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Oil and Gas Limited Partnership Lease Fund Transaction - Basic Industry Model Restructured

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OIL AND GAS LIMITED PARTNERSHIP LEASE FUND TRANSACTION—BASIC INDUSTRY MODEL RESTRUCTURED

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I. INTRODUCTION

UNITED STATES soil first yielded its oil to a well drilled for the purpose by Colonel¹ E.L. Drake near Titusville, Pennsylvania, on August 28, 1859.² The automobile was first mass-produced in 1913 in Highland Park, Michigan, by Henry Ford.³ The former event is recognized as having begun the modern oil and gas industry.⁴ The latter gave meaning to the former: it assured the oil and gas industry a future world-wide importance beyond what anyone then imagined—from both economic and strategic standpoints.⁵

More or less standard transactions developed in the oil and gas industry as demand for its products grew.⁶ Although there were end-

1. "Colonel" was apparently a moniker invented by the oil company to impress the local populace. S. SCHACKNE & N. DRAKE, *OIL FOR THE WORLD* 33 (2d rev. ed. 1960).

2. 1 J. HENRY, *THE EARLY AND LATER HISTORY OF PETROLEUM* 91-92 (1873). Drake's drill broke into an oil-bearing cavity 691/2 feet down just as he quit for the day on August 28. *Id.* He did not discover the oil until he came back to work the next day. *Id.* Other United States wells had earlier struck oil, but these discoveries had been accidents which befell people looking for water. *THE DERRICK'S HANDBOOK OF PETROLEUM* 15 (1898) [hereinafter cited as DERRICK'S]. Nevertheless, some of these earlier accidental finds had been commercial in quantity, and were what had drawn Drake to look for oil in the Titusville area. *Id.*

3. A. NEVINS, *FORD: THE TIMES, THE MAN, THE COMPANY* 469 (1954).

4. E. TIRATSOO, *OILFIELDS OF THE WORLD* 4 (1973). The use of petroleum dates back to prehistoric times. DERRICK'S, *supra* note 2, at 5. Herodotus noted the phenomenon of oil seeping from a spring on the island of Zante in the fifth century B.C. *Id.* The first recorded discovery of an oil spring in the United States was by French missionaries in 1627 near Cuba, New York. *Id.* at 6. Little besides a common commodity and profit motive united the earlier oil industry with its modern cousin in the industrial era. In the first half of the nineteenth century, the industry obtained most of its oil by distilling it from shale and bituminous coal. *Id.* at 14. However, once Drake showed that it was profitable to drill directly for oil in commercial quantities, these prior businesses all went bankrupt. *Id.*

5. See J. RAE, *THE AMERICAN AUTOMOBILE* 48-50 (1965); DERRICK'S, *supra* note 2, at 15.

6. Domestic crude oil production rose from 60 million barrels in 1900 to 250 million barrels in 1914, largely in order to satisfy the demand created by automobiles. J. RAE, *supra* note 5, at 49-50. Between the world wars, the great increase in all forms of oil-burning transportation machinery resulted in corresponding increases in the demand for petroleum. Frey, *World Patterns of Civilian Utilization*, in *WORLD GEOGRAPHY OF PETROLEUM* 354 (1950). The United States' entry into

less variations on these standard transactions, most were mere embellishments. Occasionally, however, change would rise to the level of creating an essentially new transaction, which in time would become another of the industry's standard transactions. Some of these new transactions were motivated by economics. Others were tax-motivated. Sometimes both motivations were present. To the extent tax objectives helped shape the changes, the variations often involved creativity in obtaining for the industry special tax benefits knowingly conferred by Congress. At other times the new transactions amounted to little more than abusive manipulation of the taxing mechanisms.

Congressional desire to stimulate this important sector of the economy, heightened by effective lobbying, has produced what the Internal Revenue Service (Service) acknowledges as intentionally favorable taxation treatment for the oil and gas industry. Moreover, the industry enjoys other, more broadly-based tax benefits that are aimed at stimulating the general economy. The capital gains provisions provide one such example. An aspect of capital gains taxation is the ultimate focus herein.

This article uses a well-known standard industry transaction as its starting point. It then hypothesizes a new transaction which, when combined with the standard transaction, raises some important theoretical tax issues. These combined transactions will be referred to herein as the "contemplated" or "proposed transactions."

The standard industry transaction which will serve as a point of departure for the restructuring discussed herein involves the transfer of a fractional share of a "working interest"⁷ to one who will develop the whole working interest. Gain from cash received up front by the transferor is treated as capital gain. This is in contrast to a second type of transaction which will be examined, wherein the entire working interest is subleased, with the transferor retaining only an "overriding royalty interest"⁸ instead of a fractional share of the working interest. In this kind of transaction, cash received up front by the transferor is treated as ordinary income.

World War II in 1941 also led to rapid domestic growth in oil consumption due to the increased demand for fuel and distillates from the public sector. *Id.* at 363. The growth has continued during the post-war period, with a once minimal foreign consumption now outstripping United States domestic consumption. 15 ACADEMIC AMERICAN ENCYCLOPEDIA 214 (1981). The 1960's, during which offshore drilling technology was developed, were particularly significant. *Id.* at 210.

7. For a discussion of working interests, see text accompanying note 26 *infra*.

8. For a discussion of overriding royalty interests, see text accompanying note 32 *infra*.

The purpose of this article is to investigate whether some participants in a limited partnership can obtain capital gain treatment for cash received up front in the first of these standard transactions, and then in a second, new transaction, transform their retained working interest into an overriding royalty interest without losing capital gain treatment for the cash received in the initial transaction. The policy of the Service has been to attack transactions in which this combination exists.⁹

The second of the proposed transactions involves a rearrangement of the rights of the limited partners. After this rearrangement occurs, some limited partners will own "carried working interests,"¹⁰ while others will own "overriding royalty interests."¹¹ The particular manner of placing the limited partners in these positions, and its timing in relation to the standard industry transaction with which it will be combined, are necessary steps in setting up the hypothetical fact pattern. The proposed means of accomplishing this rearrangement appear to be novel; no authority seems to have considered it. It will therefore be necessary to explore in considerable detail the tax implications of the rearrangement transaction in its own right. The conclusion reached is that the rearrangement transaction is not a recognition event and therefore gives rise to no tax.

The article will then analyze the tax consequences of combining the rearrangement with the well-known standard industry transaction noted above. This combination is certainly not common in the industry and may never have been attempted. The ultimate theoretical focus of this article is the impact of this hypothetical combination of transactions on the cash received up front in the first transaction, when a fractional share of a working interest is transferred to someone who will develop the whole working interest. Ordinarily, the cash received in the standard transaction would be capital gain if the rearrangement of rights among its recipients were not involved. The conclusion reached herein is that it remains capital gain notwithstanding the rearrangement. No authority supporting or contravening this ultimate conclusion has been found.

9. See Rev. Rul. 352, 1969-1 C.B. 34. This ruling provides in pertinent part: "Accordingly, it is held that . . . the lump-sum payment received by the taxpayer-grantor of the mineral rights in the instant case, in conjunction with the retention by him of a royalty interest, is ordinary income and not proceeds from the sale of a capital asset." *Id.* at 35. See also A. YOUNG, ARTHUR YOUNG'S OIL AND GAS FEDERAL INCOME TAXATION ¶ 19-4 (J. Houghton ed. 1984).

10. For a discussion of carried working interests, see text accompanying note 43 *infra*.

11. For a discussion of overriding royalty interests, see text accompanying note 32 *infra*.

II. STRUCTURE OF THE ENTITY

The entity contemplated is, quite simply, a limited partnership.¹² The limited partnership will arrange its internal affairs in special ways, but such arrangements will not change the nature of the entity. The general partner is expected to be a developer of mineral interests and/or a promoter of sales of limited interests in the partnership to the limited partners.

The limited partnership will set up a lease fund. At first, this fund will be held in the name of the limited partnership. The money of all partners, general and limited, will be pooled. The limited partnership will then use the money to acquire leases either from landowners or from prior owners of the leases; hence the name of "lease fund." Since the limited partners participate in the lease fund through the limited partnership, they are often called "fund participants." The general partner is also a participant in the lease fund, but the focus of this article is on the limited partners. The term "fund participants," therefore, will primarily refer to the limited partners. Thus, for the purposes of this article, a flow of cash said to move through the lease fund to a fund participant refers to a flow through the limited partnership to a limited partner.

The term "limited partnership lease fund transactions" embodies the entire set of transactions and activities contemplated, not merely the acquisition or disposition of a lease.

III. BASIC INDUSTRY TRANSACTIONS

The oil and gas industry models for limited partnership lease fund transactions follow typical patterns. A person owning all rights in certain land, including the underlying minerals in place, will transfer rights to the oil and gas in place to the lease fund of a limited partnership, retaining only a royalty interest.¹³ The landowner's goal is to arrange for the exploration and development of oil and gas under his land without having to expend his time and energies or bear the high costs and risks of exploration and development,¹⁴ while profiting through a royalty interest if oil or gas are found in sufficient quantities. While the retained royalty interest of the landowner is the most senior of all royalty interests, it is simply called a "royalty inter-

12. For a discussion of the use of limited partnerships in the oil and gas industry, see A. BRUEN & W. TAYLOR, *FEDERAL INCOME TAXATION OF OIL AND GAS INVESTMENTS* ¶ 1.05 (1983).

13. See A. YOUNG, *supra* note 9, ¶ 3-1.

14. See A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03, at 8-80.

est”¹⁵ or a “landowner’s royalty.”¹⁶ It is not called an “overriding royalty interest,”¹⁷ a term curiously reserved for a subordinate position described below.¹⁸ This transaction is considered a lease.¹⁹

Since the transaction is a lease rather than a sale, income to the landowner from the lease is treated as ordinary income, not capital gain, for purposes of federal income tax law.²⁰ It is common for the landowner to receive at the outset a lump-sum cash payment which is

15. F. BURKE & R. BOWHAY, *INCOME TAXATION OF NATURAL RESOURCES* ¶ 3.01, at 301 (1983); A. YOUNG, *supra* note 9, ¶ 11-1. *See also* A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03. *Cf.* F. BURKE & R. BOWHAY, *supra*, ¶ 2.05. A royalty interest, or simply a royalty, is a share or right to a portion of the oil and/or gas produced, although frequently it will be used to denote a right to proceeds, since cash is the usual form of a royalty payment. 3 E. KUNTZ, *OIL AND GAS* § 42.2 (1967).

16. *See* A. YOUNG, *supra* note 9, ¶¶ 11-1, -14; *see also* RESEARCH INST. OF AM., *FEDERAL TAX COORDINATOR* 2D ¶ N-4402, at 38,263 (1984) [hereinafter cited as R.I.A.].

17. *See* A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03; A. YOUNG, *supra* note 9, ¶ 11-1. *See also* F. BURKE & R. BOWHAY, *supra* note 15, ¶ 2.05.

18. For a discussion of an overriding royalty interest, see text accompanying note 32 *infra*.

19. *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 261 n.1 (1958). Bruen and Taylor state: “The Service has ruled that whenever the transferor of an operating interest retains a royalty interest in the property, the transaction is to be treated for tax purposes as a lease.” A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03, at 8-8; *see id.* ¶ 8.04, at 8-16 to -17; F. BURKE & R. BOWHAY, *supra* note 15, ¶¶ 3.02, 4.02 (a royalty interest is a non-operating or non-working interest); R.I.A., *supra* note 16, ¶ N-4104; A. YOUNG, *supra* note 9, ¶¶ 13-1, 18-1, 19-4; Rev. Rul. 352, 1969-1 C.B. 34. *See also* *Jahn v. Commissioner*, 58 T.C. 452, 455 (1972), *aff’d mem.*, 475 F.2d 1140 (6th Cir. 1973) (a lump-sum payment by drillers to landowners at the commencement of a lease constitutes a bonus or advance royalty and therefore is ordinary income). *Cf.* *Palmer v. Bender*, 287 U.S. 551 (1933) (depletion allowances not confined to those who are technically lessors). *See generally* A. YOUNG, *supra* note 9, ¶¶ 2-16, 19-2 (a sublease is a lease for purposes of economics and federal taxation law) (citing G.C.M. 22730, 1941-1 C.B. 214; Rev. Rul. 467, 1969-2 C.B. 142).

While similarities exist between the lease described and a lease for property law purposes, and while it is certainly natural to think in property law terms, the term “lease” as used here does not imply a landlord and tenant relationship nor any analogous relationship. *See* Norvell, *Negotiating and Drafting the Oil and Gas Lease for the Agricultural Landowner*, 3 AGRIC. L.J. 627, 627 (1981-82).

Transactions directly between the landowner and the lease fund are known in the industry, but it is typical for the lease fund to acquire the lease from an oil and gas company which previously dealt with the landowner. A. WILLIS, J. PENNELL & P. POSTLEWAITE, *PARTNERSHIP TAXATION* § 194.03 (3d ed. 1983). Direct acquisition from the landowner is the route used here since it more clearly conveys an understanding of the relative positions of the essential parties.

20. *See, e.g.*, *United States v. White*, 401 F.2d 610 (10th Cir. 1968) (deed conveying uranium for a lump sum payment together with a 10% royalty of gross profits held to constitute a lease, with the royalty payments taxable as ordinary income, not as long term capital gains); *accord* *Hartman Tobacco Co. v. United States*, 471 F.2d 1327 (1973). *See also* F. BURKE & R. BOWHAY, *supra* note 15, ¶ 4.03, at 404; R.I.A., *supra* note 16, ¶ N-4021; A. YOUNG, *supra* note 9, ¶¶ 18-1, 19-4. The significance of classifying income as either ordinary income or capital gain is discussed in Part VI, Policy Dimensions, *infra*.

not pledged to development.²¹ Such a lump-sum payment is in the nature of an advance royalty,²² and thus is taxed as ordinary income.²³ In economic terms, it is a bonus²⁴ paid to the landowner for entering into the lease and is typically referred to as "lease bonus income."²⁵

21. See F. BURKE & R. BOWHAY, *supra* note 15, ¶ 4.02; A. YOUNG, *supra* note 9, ¶ 13-1, at 190.

22. See *Anderson v. Helvering*, 310 U.S. 404, 409 (1940); *Jahn v. Commissioner*, 58 T.C. 452, 455 (1972), *aff'd mem.*, 475 F.2d 1140 (6th Cir. 1973); G.C.M. 22730, 1941-1 C.B. 214, 217. See also A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03[2]; F. BURKE & R. BOWHAY, *supra* note 15, ¶¶ 4.02, 4.03, at 404; R.I.A. *supra* note 16, ¶ N-4552; A. YOUNG, *supra* note 9, ¶¶ 11-4, 18-5. But see *Clark v. United States*, 587 F.2d 465 (10th Cir. 1978); *Lambert v. Jefferson Lake Sulphur Co.*, 236 F.2d 542 (5th Cir. 1956); *Daney v. United States*, 247 F. Supp. 533 (D. Kan. 1965), *aff'd*, 370 F.2d 791 (10th Cir. 1966). Cf. *Commissioner v. Engle*, 104 S. Ct. 597 (1984) (depletion allowance may be allowed as an advance royalty). For a different purpose, the Treasury Department distinguishes between a bonus and an advance royalty. See *Treas. Reg. § 1.612-3(a), (b)*, T.D. 7523, 1978-1 C.B. 192. It is not contemplated that the cash is pledged to development. If it were, the results would be different. For a discussion of the nature of a royalty, see note 24 and accompanying text *infra*.

23. *Burnet v. Harmel*, 287 U.S. 103 (1932) (even though the lease was regarded by state law as a sale of oil and gas in place, it was taxed as ordinary income under federal law); G.C.M. 22730, 1941-1 C.B. 224; Rev. Rul. 352, 1969-1 C.B. 34; Rev. Rul. 120, 1963-1 C.B. 141; F. BURKE and R. BOWHAY, *supra* note 15, ¶¶ 3.01, 4.03, at 404; R.I.A., *supra* note 16, ¶ N-4552. Accord *Commissioner v. Pickard*, 401 F.2d 615 (10th Cir. 1968); *United States v. White*, 401 F.2d 610 (10th Cir. 1968); R.I.A., *supra* note 16, ¶ N-4550. See also A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03[2]; A. YOUNG, *supra* note 9, ¶¶ 18-1, 18-5. For a discussion of the ordinary character of an advance payment, see *Jahn v. Commissioner*, 58 T.C. 452, 455 (1972), *aff'd mem.*, 475 F.2d 1140 (6th Cir. 1973); R.I.A., *supra* note 16, ¶ N-4550.

24. See, e.g., *Burnet v. Harmel*, 287 U.S. 103, 104 (1932); *United States v. White*, 401 F.2d 610, 611 (10th Cir. 1968); *Jahn v. Commissioner*, 58 T.C. 452, 454 (1972), *aff'd mem.*, 475 F.2d 1140 (6th Cir. 1973). See also A. BRUEN & W. TAYLOR, *supra* note 12, ¶¶ 3.03[1], 8.03[2]; F. BURKE & R. BOWHAY, *supra* note 15, ¶¶ 3.01, 4.02, 4.03; A. YOUNG, *supra* note 9, ¶ 18-1; G.C.M. 22730, 1941-1 C.B. 224. Although a potential theoretical ground for distinguishing between a bonus and an advance royalty would not change the tax character or treatment of the lump sum payment under discussion, it does exist. The conceptual basis on which to draw the distinction is that a bonus paid at the outset does not depend on production for its existence, either currently or later; a royalty commonly does. In oil and gas matters the dependency of the royalty payment on production seems to be at the heart of the definition of the word "royalty." The initial bonus, while closely akin to an early payment of a royalty, does not depend on present production, is not repaid if future production were to fail, and need not be (and typically is not) credited against what future production there is. An advance royalty, unlike a minimum royalty, is also not creditable against a royalty due on future production. A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 3.03[1]. The text discussion follows conventional industry usage of the terms.

25. See, e.g., *Glass v. Commissioner*, 76 T.C. 949 (1981); F. BURKE & R. BOWHAY, *supra* note 15, ¶¶ 3.01, 4.02, 4.03. Percentage depletion under the exemption for independent producers and royalty owners will not be available to the landowner with respect to the lease bonus income, even though it is a royalty, unless production occurs in the year of receipt. *Glass*, 76 T.C. at 952; see I.R.C. § 613(a), (c) (1982); Rev. Rul. 44, 1981-1 C.B. 384. This is true even when there is production in the year of payment if the payment had not been contingent upon production. *Farmer v. United States*, 689 F.2d 1017 (Ct. Cl. 1982), *rev'd on other grounds*, 104 S. Ct.

After the landowner has transferred the mineral rights, the participants of the limited partnership lease fund will hold the right to develop or "work" the oil and gas deposits. Their interest is accordingly called a "working interest."²⁶ They have the right to receive the profits from their working interest, after payment of the landowner's royalty.

What has happened so far is that the landowner has succeeded in arranging for the lease fund to pay 100% of the costs of exploring for and developing any oil or gas under his land.²⁷ However, the fund participants may entertain mixed feelings about undertaking the risks of bearing all of the exploration and development costs. If so, they may seek to have others bear all or a portion of these costs.²⁸ Were the fund participants to transfer the entire working interest, retaining only a royalty interest, the transaction would be similar to that between the landowner and the fund participants:²⁹ it would be a sublease.³⁰ The transferee in this situation is often a driller,³¹ who would then own the entire working interest. The fund participants' royalty

597 (1984). Only cost depletion may be taken. Rev. Rul. 76-34, 1976-1 C.B. 177. See Treas. Reg. § 1.612-3(a)(2), (b)(2), T.D. 7523, 1978-1 C.B. 192. But see *Herring v. Commissioner*, 293 U.S. 322 (1934); *Engle v. Commissioner*, 677 F.2d 594 (7th Cir. 1982), *rev'g* 76 T.C. 915 (1981). If the *Engle* continuation of the *Herring* case holds up, any percentage depletion taken may be subject to recapture if production is never attained. *Douglas v. Commissioner*, 322 U.S. 75 (1944).

26. *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 261 n.1 (1958); R.I.A., *supra* note 16, ¶ N-4301, at 38,261; A. YOUNG, *supra* note 9, ¶ 13-1. Some authorities refer to "working interests" as "operating interests." See A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 2.01. The terms are often used interchangeably. See, e.g., Treas. Reg. § 1.614-1(a)(2), T.D. 7261, 1973-1 C.B. 309; F. BURKE & R. BOWHAY, *supra* note 15, ¶ 2.04; R.I.A., *supra* note 16, ¶¶ N-4020, -4210; A. YOUNG, *supra* note 9, ¶ 13-1. "Operating mineral interest" is the term adopted by the Internal Revenue Code and Regulations. See, e.g., I.R.C. § 614(b), (d) (1982); Treas. Reg. §§ 1.614-0, 1.614-2, 1.614-8 (1983). Normally the term "working interest" is used with reference to oil and gas interests and the term "operating interest" is used with reference to other mineral interests. F. BURKE & W. BOWHAY, *supra* note 15, ¶ 2.04, at 203.

27. The obligation of the fund to arrange for the exploration for oil and gas and to develop the property if the oil or gas is present in economic quantities is not usually an absolute obligation. The landowner's grant of the working interest is normally for a fixed term, within which the exploration and development must be undertaken. A. YOUNG, *supra* note 9, ¶ 13-1. If the obligation were not met, the lease would simply lapse. *Id.* If the obligation were met, and if oil or gas were found, the lease would continue for the life of the deposit. *Id.*

28. See A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03[3]; F. BURKE & R. BOWHAY, *supra* note 15, ¶ 2.04, at 203.

29. See G.C.M. 22730, 1941-1 C.B. 214; A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03, at 8-8. See also F. BURKE & R. BOWHAY, *supra* note 15, ¶ 3.01.

30. *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 261 n.1 (1958); *Cox v. United States*, 497 F.2d 348 (4th Cir.), *cert. denied*, 419 U.S. 1047 (1974); *West v. Commissioner*, 150 F.2d 723 (5th Cir. 1945), *cert. denied*, 326 U.S. 795 (1946); *Hogan v. Commissioner*, 141 F.2d 92 (5th Cir.), *cert. denied*, 323 U.S. 710 (1944); *McLean v. Commissioner*, 120 F.2d 942 (5th Cir.), *cert. denied*, 314 U.S. 670 (1941); *Louisiana*

interest overrides the rights of the third-party transferee. Accordingly, it is called an "overriding royalty interest."³²

The royalties received by fund participants are taxed as ordinary income,³³ any cash paid to them at the outset being treated the same as the initial cash paid to the landowner.³⁴ Up front payments, which are not pledged to development, are common.³⁵ In economic terms, the advance royalty³⁶ is a bonus³⁷ paid to the fund participants on entering into the sublease and is accordingly referred to as "sublease bonus income."³⁸ After the transfer, the driller becomes responsible for payment of all costs of exploration and development.³⁹ Because the working interest is essentially farmed out for development to the

Land & Exploration Co. v. Commissioner, 6 T.C. 172 (1946). See generally A. BRUEN & W. TAYLOR, *supra* note 12, § 8.03; A. YOUNG, *supra* note 9, ¶ 11-15.

31. The driller is typically the oil and gas company from which the lease was acquired. WILLIS, *supra* note 19, § 194.03.

32. See A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03; F. BURKE & R. BOWHAY, *supra* note 15, ¶ 2.05; R.I.A., *supra* note 16, ¶ N-4402; A. YOUNG, *supra* note 9, ¶ 11-14. One case addressed whether the term "royalty," as used in the Treasury regulations, includes an overriding royalty, and decided in the affirmative. Aven v. United States, 78-2 U.S.T.C. ¶ 9729 (W.D. Okla. 1978) (interpreting Treas. Reg. § 1-612-3(b), T.D. 7523, 1978-1 C.B. 192).

33. See *Palmer v. Bender*, 287 U.S. 551 (1933); *Burnet v. Harmel*, 287 U.S. 103 (1932); *Cox v. United States*, 497 F.2d 348 (4th Cir.), *cert. denied*, 419 U.S. 1047 (1974); *United States v. White*, 401 F.2d 610 (10th Cir. 1968); Rev. Rul. 120, 1963-1 C.B. 141; R.I.A., *supra* note 16, ¶ N-4552. See also A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03[1] (proceeds of a lease receive ordinary income treatment). For further discussion, see note 23 and accompanying text *supra*.

34. See *Cox v. United States*, 497 F.2d 348 (4th Cir.), *cert. denied*, 419 U.S. 1047 (1974); G.C.M. 22730, 1941-1 C.B. 214, 224; *Hogan v. Commissioner*, 141 F.2d 92 (5th Cir.), *cert. denied*, 323 U.S. 710 (1944); *McLean v. Commissioner*, 120 F.2d 942 (5th Cir.), *cert. denied*, 314 U.S. 670; Treas. Reg. § 1.613A-3(a)(4), examples 5, 7(f) (proposed 1977). See also F. BURKE & R. BOWHAY, *supra* note 15, ¶¶ 3.01, 4.03, 7.16; A. YOUNG, *supra* note 9, ¶¶ 18-5, 19-4. Cf. *Palmer v. Bender*, 287 U.S. 551 (1933); *Heep Oil Corp. v. United States*, 32 F. Supp. 762 (Ct. Cl. 1940); *Cockburn v. Commissioner*, 16 T.C. 775 (1951); *Hartman Tobacco Co. v. United States*, 471 F.2d 1307 (2d Cir. 1973).

35. See note 21 *supra*.

36. See *West v. Commissioner*, 150 F.2d 723 (5th Cir. 1945), *cert. denied*, 326 U.S. 795 (1946); *Hogan v. Commissioner*, 141 F.2d 92 (5th Cir.), *cert. denied*, 323 U.S. 710 (1944); A. YOUNG, *supra* note 9, ¶¶ 11-4, 18-5. See also A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03[2]; F. BURKE & R. BOWHAY, *supra* note 15, ¶¶ 4.02, 4.03.

37. See *West v. Commissioner*, 3 T.C. 431, 447 (1944), *aff'd* 150 F.2d 723 (5th Cir.), *cert. denied*, 326 U.S. 795 (1945). See also A. BRUEN & W. TAYLOR, *supra* note 12, ¶¶ 3.03[1], 8.03[2], 8.03[3]; F. BURKE & R. BOWHAY, *supra* note 15, ¶¶ 3.01, 4.03, 7.16; A. YOUNG, *supra* note 9, ¶ 18-1; G.C.M. 22730, 1941-1 C.B. 214, 224.

38. See generally F. BURKE & R. BOWHAY, *supra* note 15, ¶ 3.01. The retention of a royalty interest only, which is a nonoperating or nonworking interest, is a lease. *Id.* ¶ 3.02, 4.01. For a discussion of the limitation of available depletion with respect to the sublease bonus income, see note 25 and accompanying text *supra*.

39. A. YOUNG, *supra* note 9, ¶ 13-1. The driller's obligation to arrange for exploration and development is not absolute. It is subject to the same types of contingencies as those discussed in note 27 *supra*.

driller, this transaction is commonly called a "farmout."⁴⁰

Alternatively and very typically, however, fund participants will wish to retain the right to a share of proceeds that is greater than just an overriding royalty interest. In that case, they will continue their original undertaking concerning payment of costs, but only as to a portion of those costs. The driller in this situation undertakes to pay the rest of the costs, and in return, becomes entitled to a share of the proceeds. The driller's share depends on that of the fund participants: the larger the share of proceeds they keep, the larger their share of costs, and thus the smaller the driller's share of costs and proceeds. The continuing liability of the fund participants for a portion of the costs means their interest is still a working interest.⁴¹

Although the driller could simply acquire a portion of the working interest of the fund participants, thereby placing himself in the same position as the participants, it is more common to further divide responsibility to pay costs. The additional dimension of this division relates to timing. Commonly, the driller will undertake to pay 100% of the costs during the period of time prior to the "casing" point.⁴² After the casing point is reached, the driller and the fund participants will share costs. By paying all the costs up to the casing point, the driller carries the fund participants to the "casing" point. The interest of the fund participants is therefore called a "carried working interest."⁴³ Concomitantly, the driller's interest is referred to as a

40. See A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03[3]; F. BURKE & R. BOWHAY, *supra* note 15, ¶ 2.04, at 204. The fund participants are the farmers. The farmout concept applies with equal force to the lease with the landowner, wherein the fund participants are the farmees. However, the term "farmout" does not normally appear to be used in this concept. Its normal usage seems to be in transactions entered into by persons owning a working interest where the working interest has already been severed from the fee. The working interest owned by the landowner before he enters into the lease is an interest included within the fee. In a farmout, part or all of the working interest is assigned to a farmee who undertakes part or all of the costs of developing the property. See A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03[3], at 8-13; F. BURKE & R. BOWHAY, *supra* note 15, ¶ 7.02.

41. See I.R.C. § 614(d); Treas. Reg. § 1.614-2(b), T.D. 6859. 1965-2 C.B. 185; A. YOUNG, *supra* note 9, ¶ 13-1.

42. "Casing" point is the depth at which the operator believes, on the basis of geological evaluation, that hydrocarbons may be found. In other words, casing point is the depth to which the operator has obligated itself to drill. When the casing point is reached, the well is tested for the presence of hydrocarbons, usually by an electronic induction log. This log furnishes information on the basis of which a decision is made whether to complete the well. If the logs do not justify completion, the well is a "dry hole," which is then plugged and abandoned. See *Brountas v. Commissioner*, 73 T.C. 491, 500 (1979), *rev'd on other grounds*, 692 F.2d 152 (1st Cir. 1982). The casing point is chosen before drilling begins and is usually near the midpoint of the stratum in which oil is thought to lie. To the extent oil is found at all, it is not uncommon to find it before the casing point is reached.

43. See A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 3.05[2](d)(iv); F. BURKE & W.

“carrying working interest.”⁴⁴ The continuing liability of the fund participants for a portion of the costs after the casing point means that their interest is still a working interest.⁴⁵ This transaction is also called a “farmout.”⁴⁶

In this kind of farmout, the driller is liable for all costs attributable to his share of the working interest. However, he has the right to recoup those costs attributable to the carried working interest, but only out of the share of proceeds to which the owners of the carried working interest are entitled. Excepting this right of recoupment, the two interests become the same at the casing point; the only remaining differences between them relate to the share of proceeds to which each is entitled and the share of costs for which each is responsible.

When the fund participants thus remain at risk by retaining more than an overriding royalty interest, they are transferring absolutely a portion of what they had, rather than placing the driller in a subordinate position. Under general, traditional analysis the transfer seems less like a lease and more like a sale or exchange of either a capital asset or property used in a trade or business. Such a sale or exchange would, of course, produce capital gain rather than ordinary income.⁴⁷ However, principles of general applicability have not always been followed for the oil and gas industry. Special characteristics of the industry, combined with a peculiar history of the development of applicable law, have complicated the classification of this transaction.

If the fund participants transferred absolutely all of their working interest for cash, the proper classification of the transaction would follow the general traditional analysis. It would be a sale.⁴⁸ And be-

BOWHAY, *supra* note 15, ¶ 2.08; R.I.A., *supra* note 16, ¶¶ N-4301, at 38,261, N-4205 at 38,255; A. YOUNG, *supra* note 9, ¶ 16-1.

44. For a list of authorities on carrying working interests, see note 43 *supra*.

45. For a definition of a working interest, see A. YOUNG, *supra* note 9, ¶ 13-1. A working interest is sometimes referred to as an operating interest. *Id.* For definitions of an operating mineral interest, see I.R.C. § 614(d) (1982); Treas. Reg. § 1.614-2(d), T.D. 6859, 1965-2 C.B. 185.

46. For a definition of a farmout, see A. BRUEN & W. TAYLOR, *supra* note 12, ¶¶ 8.03[3], 8.04 n.59; F. BURKE & R. BOWHAY, *supra* note 15, ¶ 7.02. For a description of other types of sharing arrangements, see A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.04.

47. See A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03. For a further discussion of income characterization, see note 113 and accompanying text *infra*. Whenever capital gain is discussed herein as an outcome or a potential outcome, it is assumed that the applicable holding period necessary for long-term capital gain treatment has been met.

48. See A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03[3]; F. BURKE & R. BOWHAY, *supra* note 15, ¶ 3.03. For a discussion of the tax consequences of classification as a sale, see A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.04.

cause a capital gain asset⁴⁹ is involved, the gain would be taxed as capital gain rather than ordinary income.⁵⁰

In contrast, if the fund participants transferred absolutely only a

49. "Capital gain asset" is used herein to refer to assets, the sale of which produces capital gain regardless of whether the asset is a capital asset, or a § 1231 asset. For a discussion of capital assets, see note 135 and accompanying text *infra*.

50. G.C.M. 22730, 1941-1 C.B. 214. See *Urschel v. Jones*, 83 F. Supp. 600, 609 (W.D. Okla.), *app. dismissed per stipulation*, 178 F.2d 663 (10th Cir. 1949); *Engle v. Commissioner*, 13 T.C.M. (CCH) 520, 526 (1954); *Robinson v. Commissioner*, 13 T.C.M. (CCH) 921, 925 (1954); F. BURKE & R. BOWHAY, *supra* note 15, ¶ 3.03. Cf. *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 266 n.5 (1958) (quoting in dictum that the Commissioner's view that assignment for gain of an in-oil payment right which extends "over a period of less than the life of the depletable property interest from which it is carved" should be treated as ordinary income does not apply where the entire depletable interest or fractional share assigned extends "over the entire life of the property") (citing I.T. 4003, 1950-1 C.B. 10, 11). However, in this standard transaction, a fractional share of a working interest, also a depletable interest, is transferred for the entire life of the working interest. See also *Bailey v. Commissioner*, 21 T.C. 678, 686 (1954).

Since these cases are both illustrative of and crucial to this article's thesis, it may be useful to carefully explore the facts of each case so as to better compare them with the transactions proposed herein.

Urschel was decided under old I.R.C. § 117, the equivalent capital gain provision of the 1939 Code, and involved years prior to the 1939 codification. 83 F. Supp. at 601. Directly and indirectly, substantial working interests in both producing leases and undeveloped leases were sold before death by a predecessor in interest. *Id.* at 602. This sale occurred in 1929, and the decedent parted with all his interest in the producing leases, but with only an undivided half interest in the undeveloped leases. *Id.* Decedent was not a dealer in leases and did not acquire them for purposes of sale. The purchaser was to develop and operate the undeveloped leases for the benefit of itself and the decedent. *Id.* Decedent also parted with other valuable properties in the sale. *Id.* at 603. He received \$27,500,000 cash up front plus a contingent right to receive \$6,000,000 more, when and if production from all of the transferred leases exceeded \$30,000,000. *Id.* In 1936, the decedent's successors in interest sold a one-half interest in the contingent obligation, together with other valuable properties to the Transwestern Oil Company. *Id.* at 604. In 1941, they sold the other one-half interest in the contingent obligation to the same corporation. *Id.* At issue was the proper treatment of the proceeds from the 1941 sale.

The Commissioner argued that the 1941 sale was not the sale of a capital asset but rather the "collection of a one-half interest in a contingent account receivable." *Id.* at 607. The court held that the sale involved a capital asset which, having been held for longer than the two year requisite holding period, produced long-term capital gain. *Id.* at 609. This conclusion seems necessarily predicated on the view that what was sold to create the contingent obligation was itself a capital asset, although the court did not so state, and did indicate that the contingent obligation was not an economic interest in the leases. *Id.* This, in turn, leads to the conclusion that the cash received up front also produced capital gain, although this was not an issue in the case. The court did indicate, however, that decedent reported the cash as capital gain in 1929 and that the Commissioner had accepted this treatment. *Id.* at 603.

Robinson was also decided under old I.R.C. § 117 of the 1939 Code, and involved the sale of three oil and gas leases. 13 T.C.M. (CCH) at 922-23. These leases were not producing current income for the taxpayer and it appears they were unproven. *Id.* at 922. The taxpayer owned several other leases and over a period of years sold many interests, but normally to a select group of business associates. *Id.* The three sales at issue were to these business associates. *Id.* at 923. The sales were precipitated

fraction of their working interest in exchange for cash or other property pledged to development by the driller, then the transaction would be classified as neither a lease⁵¹ nor a sale.⁵² It would be a sharing arrangement⁵³ in which no gain or loss would be recognized.⁵⁴ The form of the driller's contribution, whether it be in cash,

by the taxpayer's need for cash in order to cover his share of costs for an unrelated well. *Id.*

The Commissioner claimed that the leases sold were property held primarily for sale in the ordinary course of a trade or business due to the number of sales the taxpayer made over a long period of time. *Id.* at 922. The court found, however, that the leases were held for investment and allowed long-term capital gain treatment. *Id.* at 925. It is not clear whether the sales at issue involved whole leaseholds or fractional shares. It does seem, however, that the taxpayer parted with all of whatever interest he had in the particular leases. The case is partially distinguishable in that the sales did not contemplate that either seller or buyer would undertake development of the leases sold. The case does, however, support the proposition that the sale of a working interest produces gain which will be treated as long-term capital gain when held for longer than the requisite holding period. 13 T.C.M. at 925.

Engle was also decided under old I.R.C. § 117 of the Code. 13 T.C.M. (CCH) at 520. In *Engle*, numerous fractional interests in oil and gas leases were sold. *Id.* at 521. The taxpayer never solicited sales, however, and normally held on to his interests for profits from development and production. *Id.* at 520-21. The Commissioner's effort to treat the taxpayer as a dealer due to the number of sales and the time over which they were made was unsuccessful. *Id.* at 526. No argument was made that the fractional shares were not other property whose sale at a gain after the requisite six months holding period would result in long-term capital gain. Thus, long-term capital gain treatment followed. *Id.* The case is partially distinguishable in that the interests transferred were of producing properties and any further development of the working interests would not be done by the transferees. *Id.* at 522. However, the transferees were liable on a continuing basis to pay a share of costs. *Id.* at 523. The case can therefore be seen as mandating long-term capital gain treatment for the sale of a fractional share of a working interest, although a carried arrangement was not involved.

In *Bailey*, the taxpayer transferred fractional shares of oil and gas leases for cash. 21 T.C. at 681. The transferor used the cash for development of wells, rather than requiring the transferee to undertake development. *Id.* Under the equivalent provision of § 117 of the 1939 Code, long-term capital gain treatment was accorded to gain realized from the transfers of property held for more than the requisite six months. *Id.* at 686. An unsuccessful attack by the Service was grounded solely on the claim that the taxpayer was a dealer, and that he was holding the interests for sale in the ordinary course of his trade or business. *Id.* This claim rested on the large number of sales and the time over which they were made. *Id.* No argument was made that the fractional shares were not otherwise property whose sale at a gain after the requisite holding period would result in long-term capital gain. The case is somewhat distinguishable, however, for two reasons: first, the transferor used the cash for development, rather than contemplating that the transferees would undertake development; second, there seems to have been no continuing responsibility for some transferees to pay a share of costs.

51. F. BURKE & R. BOWHAY, *supra* note 15, ¶ 3.05, at 304.

52. See A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03[3]; F. BURKE & R. BOWHAY, *supra* note 12, ¶ 3.05.

53. See G.C.M. 22730, 1941-1 C.B. 214; A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03[4]; F. BURKE & R. BOWHAY, *supra* note 15, ¶¶ 3.05, 7.01, 7.09. Although the concept is very old, the sharing arrangement has not been the subject of any case.

54. A. BRUEN & W. TAYLOR, *supra* note 12, ¶¶ 8.03[3], [4]; F. BURKE & R.

other property, or services, would be irrelevant as long as the contribution is pledged to, and ultimately used for, development.

Authorities agree that the sharing arrangement is a nontaxable occurrence.⁵⁵ They are not consistent, however, in their reasons for this result. Disagreement centers on the nature of the transaction. Under one view, the transaction is nontaxable because it is not an exchange.⁵⁶ It is considered a sharing, or pooling together, similar to the joining of assets which occurs when a partnership or joint venture is formed.⁵⁷ This does not mean that the transaction is a partnership or joint venture because the requisite characteristics of those business forms other than sharing or pooling are not present.⁵⁸ Under this view, lack of an exchange means that neither party has realized anything.⁵⁹ Because no realization has occurred, there is nothing to recognize under the current policy of not taxing mere appreciation.⁶⁰ This "no exchange" characterization, however, is a legal fiction, although it is one that is completely compatible with tax treatment of other situations involving the coming together of different parties to share or pool their resources for mutual profit.⁶¹

Under a second view, an exchange is said to occur, but the transaction is still considered nontaxable. An exchange occurs because the parties are transferring rights: the fund participants transfer to the driller a fraction of their working interest in property;⁶² in exchange, the driller agrees to make a contribution in the form of development, receiving an interest in the property in return.⁶³ This second view, which sees an exchange, denies the taxability of any gain realized in that exchange based on economic or social policy considerations, rather than on the theory of taxation.⁶⁴ While creating some theoretic-

BOWHAY, *supra* note 15, ¶¶ 3.01, 7.04, 7.19. See also I.R.C. § 636 (1982) (income tax treatment of mineral production payments).

55. See F. BURKE & R. BOWHAY, *supra* note 15, ¶ 7.04.

56. *Id.* ¶¶ 3.01, .03.

57. *Id.* ¶ 7.04.

58. *Id.*

59. *Id.*

60. See *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943); *Rogan v. Blue Ridge Oil Co.*, 83 F.2d 420 (9th Cir.), *cert. denied*, 299 U.S. 574 (1936); *Thompson v. Commissioner*, 28 F.2d 247 (3rd Cir. 1928); G.C.M. 22730, 1941-1 C.B. 214; F. BURKE & R. BOWHAY, *supra* note 15, ¶ 7.04. The transferor is thought to have no benefit other than the mere unrealized appreciation which the transferee's contribution represents. F. BURKE & R. BOWHAY, *supra* note 15, ¶ 7.04.

61. For a discussion of these other situations, see text accompanying notes 56-60 *supra*.

62. See F. BURKE & R. BOWHAY, *supra* note 15, ¶ 7.08.

63. *Id.* ¶ 7.01. See also G.C.M. 22730, 1941-1 C.B. 214.

64. Incorporation by more than one party, creation of partnerships, and joint ventures are all examples of nontaxable exchanges. Justifying nontaxation in all

cal difficulties, the second view better describes reality. Situations like the sharing arrangement involve a coming together and an exchange of property rights, but they do not involve parties who then go their separate ways, leaving behind the property rights they transferred and taking with them the property rights they received.⁶⁵ In one respect, the sharing arrangement is more akin to the joint venture, since each party to a sharing arrangement retains separate ownership of some of the assets he brought to the arrangement. For example, the driller continues to own the drilling rig. However, since the interests of the fund participants and the driller are fractional interests in the whole of the working interest, the sharing arrangement in this respect is much like a corporate or partnership arrangement in which, albeit through the intervening entity, the parties own undivided interests in the whole of the underlying assets. Tenancy in common would be a property law equivalent.

Unlike the above analogies, however, the transactions contemplated herein include an additional element—cash *not* pledged to development. This is cash transferred up front by the driller to the fund participants. Like a sharing arrangement, the fund participants transfer absolutely only a portion of their working interest to the driller. But unlike a sharing arrangement, the driller also pays a cash bonus to the fund participants and agrees to make contributions to the development of the property. The contemplated transaction as a whole, therefore, does not fit the general traditional analysis of a sale. Neither does it fit the sharing arrangement concept. It is mixed,⁶⁶ with characteristics of both a sale and a sharing arrangement.⁶⁷ Because the transaction is divisible into its constituent parts,⁶⁸ it is referred to as a “divisible sharing arrangement.”⁶⁹ Each part is treated

these situations may be a policy favoring the tax-free joining of capital to stimulate economic efficiency, capital formation and job creation. Nontaxation of sharing or pooling is sometimes referred to as the “pool of capital doctrine.”

65. An example of the latter transaction would be a § 351 transfer where the taxpayer transferred property to a newly organized corporation, and received stock in exchange. See I.R.C. § 351 (1982).

66. See F. BURKE & R. BOWHAY, *supra* note 15, ¶¶ 7.04, .06.

67. *Id.* ¶¶ 7.06, .19.

68. *Id.* ¶¶ 7.01, .06, .19.

69. *Id.* ¶¶ 7.01, .19. The concepts of a sharing arrangement as a nonrecognition event and a divisible sharing arrangement as a partial nonrecognition event (depending on the absence or presence of a cash bonus) are equally applicable to the lease with the landowner and to a farmout sublease to a driller in which the fund participants keep only an overriding royalty interest. However, these concepts are not terribly useful because nonrecognition (except of a cash bonus) for those transactions does not depend on the complete or divisible sharing arrangement concepts. Characterization of these transactions as a lease or sublease is sufficient to explain nonrecognition. The act of entering into a lease is generally not a recognition event. Perhaps

according to its nature:⁷⁰ the portion involving the cash bonus is a sale⁷¹ and the balance of the transaction is a sharing arrangement.⁷²

This is the standard industry model⁷³ used for comparison and as

this explains why the terms "sharing arrangement" or "divisible sharing arrangement" do not seem to be used in referring to those transactions.

70. See F. BURKE & R. BOWHAY, *supra* note 15, ¶ 7.01, at 701. As previously mentioned, the sharing arrangement has not been the subject of any case even though the concept is quite old. See note 53 *supra*. The firmest authority for the concept is the 1941 G.C.M. 22730, 1941-1 C.B. 214. The divisible sharing arrangement has not been the subject of case law or even of a Service ruling. F. BURKE & R. BOWHAY, *supra* note 15, ¶ 7.14. This may be due to the fact that proper tax treatment of sharing arrangements is now considered settled law and the treatment of divisible sharing arrangements follows naturally. However, at least one authority considers the rules applicable to sharing arrangements generally to be "only in the formative stage." *Id.* ¶ 7.19.

71. See F. BURKE & R. BOWHAY, *supra* note 15, ¶¶ 3.03, 7.06, 7.19.

72. *Id.* ¶¶ 7.01, .06. Commentators will sometimes classify a divisible sharing arrangement as either a sale or a sharing arrangement, depending on which it primarily is. This does not, however, lead them to confuse the proper tax treatment for the two parts. See *id.* ¶ 3.05.

73. Important to the overall scheme of taxation of oil and gas transactions is a determination of whether certain owned interests are economic interests. The presence of an economic interest is one requirement for availability of depletion deductions. See, e.g., *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, 313-15 (1956); *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25, 32 (1946); *Palmer v. Bender*, 287 U.S. 551 (1933); G.C.M. 22730, 1941-1 C.B. 214; *Treas. Reg. § 1.611-1(b)* (1968); A. BRUEN & W. TAYLOR, *supra* note 12, ¶¶ 7.03, .03[2]; A. YOUNG, *supra* note 9, ¶ 11-2. This is the primary importance of classification of an interest as an economic interest. F. BURKE & R. BOWHAY, *supra* note 15, ¶ 2.09; A. YOUNG, *supra* note 9, ¶ 11-1. Development of the concept of economic interest was founded on the notion that substantive ownership, not legal title, is the relevant inquiry. *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308 (1956); *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599 (1946); *Palmer v. Bender*, 287 U.S. 551 (1933); *Estate of Weinert v. Commissioner*, 294 F.2d 750 (5th Cir. 1961); *Treas. Reg. § 1.611-1(b)*, T.D. 7261, 1973-1 C.B. 309; A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 7.03. Since availability of depletion deductions is not within the focus of this article, the concept of economic interest will not be further discussed. For authorities on economic interest classification of landowner's royalty, see *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599 (1946); *Palmer v. Bender*, 287 U.S. 551 (1933); *Commissioner v. Laird*, 91 F.2d 498 (5th Cir. 1937); I.R.C. § 611(b)(1) (1982); G.C.M. 22730, 1941-1 C.B. 214; A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 7.03[1], at 706; A. YOUNG, *supra* note 9, ¶ 9-18. For a discussion of economic interest classification of working interests, see A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 7.03[1]; A. YOUNG, *supra* note 9, ¶¶ 2-9, 9-18. See also *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946); *Palmer v. Bender*, 287 U.S. 551 (1933); *Lynch v. Alworth-Stephens Co.*, 267 U.S. 364 (1925); *Greensboro Gas Co. v. Commissioner*, 30 B.T.A. 1362 (1934), *aff'd*, 79 F.2d 701 (3d Cir.), *cert. denied*, 296 U.S. 639 (1935); I.R.C. § 611(b)(1) (1982); G.C.M. 22730, 1941-1 C.B. 214. For a discussion of economic interest classification of overriding royalty interests, see *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946); *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599 (1946); *Thomas v. Perkins*, 301 U.S. 655 (1937); *Palmer v. Bender*, 287 U.S. 551 (1933); *Louisiana Land & Exploration Co. v. Commissioner*, 6 T.C. 172 (1946); *West v. Commissioner*, 3 T.C. 431 (1944), *aff'd*, 150 F.2d 723 (5th Cir. 1945), *cert. denied*, 326 U.S. 795 (1946); A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 7.03[1]; A. YOUNG, *supra* note 9, ¶ 2-6. For a discussion of economic interest classification of carried and carrying worrying interests, see *Burton-Sutton*

a point of departure for purposes of the analysis which follows. The focus of this article is on the proper characterization of gain from the cash bonus paid up front by the driller to the fund participants in this divisible sharing arrangement transaction.

IV. THE *INTER SE* RESTRUCTURING

A. *The Inter Se Rearrangement*

While the position of the fund participants at the close of this standard transaction is advantageous, there may be some who would prefer to be in a different position.⁷⁴ This could be accomplished as follows. First, all of the foregoing should be done as part of one transaction, which will take all fund participants to precisely the point already described. A separate transaction which does not involve all of the prior parties would then follow. The parties to this transaction will consist only of the fund participants, a transaction accordingly referred to as the "*inter se* transaction," since the fund participants are now transacting among themselves, or *inter se*.⁷⁵ The driller, who acquired the carrying working interest, is not a party to the *inter se* transaction.

The *inter se* transaction involves a rearrangement of the rights of the fund participants. When the transaction is completed, those fund participants who prefer a higher share of proceeds available to a carried working interest will receive the entire carried working interest of all fund participants, subject to the landowner's royalty and the overriding royalty interest discussed below. These fund participants are marshalled into Group 1. Those fund participants who prefer the greater safety of an overriding royalty interest in which they will have no further responsibility for any costs at any time, and who therefore are willing to accept a smaller share of proceeds, will be marshalled into Group 2.⁷⁶ Regardless of the route for marshalling the various

Oil Co. v. Commissioner, 328 U.S. 25 (1946); G.C.M. 22730, 1941-1 C.B. 214; A. YOUNG, *supra* note 9, ¶ 2-9. See also text accompanying notes 26-46 *supra*. All of the property interests central to the discussion in this article are economic interests.

74. The most common reason for some of the fund participants to prefer a different position is a desire to decrease their risk in the venture in return for a smaller portion of the proceeds.

75. While the *inter se* transaction may occur after the initial transaction, it is contemplated that it will occur prior to the casing point, and, if earlier, prior to the time the well is proven. For a discussion of the importance of the sequence of these events, see text following note 103 *infra*.

76. The intent of a Group 2 participant at the time of the initial transaction to transfer all operating rights subsequent to the initial transaction does not convert the working interest he has after the initial transaction into a nonworking interest. Treas. Reg. § 1.614-5(g) (1961). Therefore, the sale or exchange character of the

rights among the Group 1 and the Group 2 participants, the Group 1 participants will end up with a carried working interest and the Group 2 participants will end up with an overriding royalty interest.

It appears that the *inter se* transaction itself will not be a recognition event and therefore no current tax cost will be present.⁷⁷ A total of five alternative tax theories explain why the transaction is not a recognition event. As to the rearrangement itself, there are two competing ways of viewing how the property rights are marshalled in the *inter se* transaction. The tax reasons for nonrecognition vary with the particular marshalling view adopted.

Under one view of marshalling, the Group 1 participants agree to pay the obligations of the Group 2 participants for all future costs. In return, the Group 1 participants receive the right to a larger share of proceeds than they had previously held. This increment is carved out of the interest held by the Group 2 participants prior to the *inter se* transaction. The increment is not an overriding royalty interest because of the corresponding responsibility for costs which flows with it to the Group 1 participants.⁷⁸ The share of the rights to proceeds to which the Group 2 participants will be entitled from the overriding royalty interest⁷⁹ is *retained* by them out of the share of rights they already had. It is set at such a level that no cash will change hands in the *inter se* transaction. The share of proceeds retained by the Group 2 participants will obviously be smaller than it was before the *inter se* transaction since the decrement is what must go to the Group 1 participants to induce them to increase their responsibility to pay costs. Since the Group 1 participants will end up with a right to a share of proceeds subject to a share of costs, but with the benefit of the carry, they will have a carried working interest. Since the Group 2 participants will be entitled to a share of proceeds without any responsibility to pay costs, they will have an overriding royalty interest.

Alternatively, under a second view of marshalling, the Group 2

initial transaction with its attendant capital gain treatment is not automatically jeopardized.

77. Little time may have passed between the date of acquisition of the working interest by lease from the landowner and the date of the *inter se* transaction. With little time for appreciation, the gain may not be great and recognition may not matter. Of course, recognition may matter if intervening time or a significant intervening event has caused a substantial increase in value. For instance, obtaining a driller to develop the property and carry the limited partnership's fraction of the working interest to the casing point may be such an event.

78. See I.R.C. § 614(d) (1982); Treas. Reg. § 1.614-2(b), T.D. 6859, 1965-2 C.B. 185 (the increment is a working interest).

79. Since the Group 2 participants will be entitled to a share of proceeds without any responsibility to pay costs, they will have an overriding royalty interest.

participants simply transfer their entire share of the carried interest to the Group 1 participants and receive in return an overriding royalty interest from the Group 1 participants. The end result is identical to the result attained under the first view of marshalling. However, there is an important difference between the two views. Under the second view *all* of the rights to proceeds of the Group 2 participants are transferred to the Group 1 participants. The royalty interest which the Group 2 participants will have must therefore be carved out of the proceeds rights of the Group 1 participants. Under the first view it was *retained* by the Group 2 participants out of rights they already had.⁸⁰

These divergent views are not without precedent in other areas of the law. Two examples, a transfer of a fee with reservation of a life estate, and a sale and leaseback, though far from analogous to the *inter se* transaction, may be illustrative. The concept of a reserved life estate is commonly accepted, even though the rights represented could simply be transferred away and then transferred back. Instead, the rights are thought to be retained because there is no point in transferring and then, so to speak, “untransferring” them. Conversely, in a sale and leaseback the idea that the seller receives certain rights back as lessee is generally accepted, even though those rights were lesser-included rights in the seller’s hands prior to the transaction and could therefore be thought of as retained.

Which view is adopted may be an essentially arbitrary decision.

B. *Tax Consequences of the Inter Se Transaction*

There are five separate bases for concluding that the *inter se*

80. When a landowner leases out his mineral rights, his royalty interest is thought to be retained. When fund participants deal with a driller, the carried working interest is also thought to be retained. These comparative transactions may suggest adoption of the first view of the *inter se* transaction. In both of these somewhat analogous situations the landowner or the fund participants, as the case may be, already had a right to proceeds out of which their resulting right to proceeds could be taken. In neither situation, however, did the other party to the transaction own any right to proceeds beforehand. In those situations no source exists out of which the right to proceeds of the landowner or the fund participants could be carved, unless, as seems to be accepted in the sale and leaseback situation discussed in the text, the carving out occurs after the transfer. The real source, therefore, must be in proceeds rights they already had. In short, they *retain* proceeds rights which were lesser-included interests in what they already had. By sharp contrast, in the *inter se* transaction, the Group 1 and Group 2 participants both have proceeds rights before the transaction which are precisely the same (except for proportional differences), and either of which could be the source of the overriding royalty interest of the Group 2 participants. Unlike the somewhat analogous situations used for comparison, it is therefore conceptually possible for the *inter se* transaction to be interpreted according to the second view.

transaction is not a recognition event, and therefore not taxable. The reasons for reaching this conclusion vary with one's view of how the assets are marshalled. The five tax approaches to the matter are as follows: (1) the *inter se* transaction is a lease; (2) the *inter se* transaction is an exchange in which the Group 2 participants transfer a portion of their right to proceeds, and in return the Group 1 participants relieve them of responsibility for potential costs which are not yet a debt; (3) the *inter se* transaction is an exchange in which the Group 2 participants transfer a portion of their proceeds rights and in return the Group 1 participants relieve them of responsibility for costs, which, even if viewed as a debt, are of unknown amount and must be given open transaction treatment; (4) the *inter se* transaction is a mere shift in interests in the nature of a sharing arrangement; (5) the *inter se* transaction is a like-kind exchange. The first three tax approaches to the *inter se* transaction are compatible only with the first view of how the assets are marshalled. The fourth approach is compatible with either view. The fifth approach is compatible with the second view only.

1. *First Approach*

If the transaction is perceived as an exchange of rights, then the *inter se* transaction closely parallels the original transaction between the landowner and the fund participants.⁸¹ It also follows, very closely, what would have occurred if the fund participants had retained only an overriding royalty interest rather than a carried working interest in their dealings with the driller.⁸² The *inter se* transaction under this approach emerges as a lease, albeit a "sub-sublease." The Group 2 participants transfer all their interest in the carried working interest (retaining their overriding royalty interest) to the Group 1 participants who undertake the pre-existing obligation to pay the future costs of the Group 2 participants. This situation is the same as that in which the fund participants transfer all their interest in the working interest (subject to retention of an overriding royalty interest) to the driller who undertakes to pay the pre-existing obligation of the fund participants to the landowner to pay all future costs. If the latter is a lease (or a sublease), so is the former.⁸³ Leases are not taxable for a cash basis taxpayer until cash is received (and none is re-

81. For a discussion of the transaction between the landowner and the fund participants, see text accompanying notes 13-26 *supra*.

82. For a discussion of the fund participants' retention of carried working interests, see text accompanying notes 42-46 *supra*.

83. For a discussion of this sublease, see text accompanying notes 29-30 *supra*.

ceived in the *inter se* transaction) or, for an accrual basis taxpayer, until cash is earned over time. Thus, the mere act of entering into the lease is not a recognition event for either type of taxpayer. Lease treatment is in accord with the first view of how the assets are marshalled in the *inter se* transaction.⁸⁴

2. *Second and Third Approaches*

If what happens is perceived as an exchange, it could be considered a transfer of a fraction of a carried working interest (subject to a reserved overriding royalty interest by the transferor) in exchange for an undertaking by the transferee to pay the transferor's obligation for future costs. Under tax law, the act of assuming someone else's debt is generally deemed the equivalent of paying him cash.⁸⁵ The issue of taxable income due to relief from indebtedness would generally arise.

Nevertheless, there are two reasons why nonrecognition should apply. First, the debt does not exist at the time of the *inter se* transaction. The debt is contingent and will only arise if the driller chooses to develop the working interest.⁸⁶ The driller customarily is no more obligated to the fund participants to proceed than are the fund participants obligated to the landowner to proceed. Either party could simply let his interest lapse. Basically, the payment of future amounts is more in the nature of contributions which might be required in the future than of future payment of a present debt. The person undertaking to pay the costs is undertaking that and no more. A second reason for nonrecognition is that open transaction treatment should be available if the Service were to contend that the transaction involves a sale with relief from a debt because there is no way of measuring the quantity of costs which have been undertaken at the time of the "sale." These treatments are necessarily compatible only with the first view of how the assets are marshalled in the *inter se* transaction.⁸⁷

84. It cannot fit the second view because the overriding rights are viewed as retained, not as transferred with the rest of proceeds rights, then carved out and transferred back.

85. See, e.g., *Crane v. Commissioner*, 331 U.S. 1 (1947); I.R.C. § 61(a)(12) (1982).

86. See note 122 and accompanying text *infra*. If the undertaking by the Group 1 participants were viewed as an immediate payment of cash to the Group 2 participants, the *inter se* transaction could be restructured so that the Group 2 participants would remain liable for costs to the driller and the Group 1 participants would be obligated to pay equivalent sums to the Group 2 participants. Should the Service contend that this transaction is a sale, it would have to allow installment reporting of the income.

87. For a discussion of the first view, see notes 78-79 and accompanying text *supra*.

3. *Fourth Approach*

Had the fund participants retained only an overriding royalty interest rather than a carried working interest when they first transacted with the driller, and also retained a right to convert the overriding royalty interest into a fraction of the working interest after payout or after an otherwise specified amount of production, the fund participants would be in a position to engage in a transaction somewhat akin to the *inter se* transaction. The fund participants on conversion would be transacting with a party with whom they already share economic rights in the same oil and gas in place. Conversion of the overriding royalty interest into a fraction of the working interest has been called a mere "shift in interests," rather than a recognition event.⁸⁸ This seems like a soft way of calling it a "sale or exchange", and therefore a curious reason for not recognizing the event. However, since the lease transaction setting up the overriding royalty interest with a conversion right seems itself to be a sharing arrangement, and therefore not a recognition event notwithstanding the shifts in interest involved,⁸⁹ the logic of the sharing arrangement concept can reasonably be seen to include subsequent mere "shifts in interests." The transfer of the obligation to pay future costs can be seen as the transfer of an obligation to make a future contribution to the shared undertaking. If actual contribution is not considered a recognition event, then neither should be a change in the party who will make the contribution.

This conversion of an overriding royalty interest into a working interest is not just analagous to the *inter se* transaction. It is the *inter se* transaction viewed from the other side (except for the conversion right), although it is not employed in the same context as the *inter se* transaction. In the *inter se* transaction, the Group 2 participants part with a share of their right to proceeds and, accordingly, are relieved of their share of costs. In the present comparative transaction, the driller parts with a share of proceeds and is relieved of an attendant share of costs, while owners of the overriding royalty interest who convert that interest into a working interest acquire that share of proceeds and undertake those costs. The position of the driller, in terms of what he gives and what he receives in the present comparative transaction, is the same as that of Group 2 participants in the *inter se* transaction. The situation of the former owners of the overriding royalty interest who converted that interest into a working interest in the

88. See A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.03[3].

89. For a discussion of the sharing arrangement, see note 69 and accompanying text *supra*.

present comparative transaction with the driller is the opposite side of the situation of the Group 2 participants in the *inter se* transaction. Since the conversion is a mere shift in interests,⁹⁰ the *inter se* transaction should also be treated as a mere shift in interests.

The presence of a right to convert in the present comparative transaction may be a distinction but, as discussed in Part V of this article, it need not be.⁹¹ Nor should this potential distinction matter. The point in time of conversion (and therefore the quantity of costs whose responsibility is shifted) is also different; this, too, should not matter because the only changes are to the values involved, not the nature of the transaction.

Like the present comparative transaction, the *inter se* transaction should not be a recognition event. Implicit in the conclusion that the *inter se* transaction is a mere shifting of interests and not an exchange may be the first view of how the assets are marshalled in the *inter se* transaction.⁹² However, this conclusion is also not incompatible with the fiction in the second view of how the assets are marshalled: that there is no exchange under the sharing arrangement since no rights are transferred.⁹³

4. *Fifth Approach*

Ignoring boot issues related to equipment, it may also be possible to view the comparative transaction of conversion of an overriding royalty interest into a fraction of working interest as a like-kind exchange⁹⁴ of economic interests in minerals in place. If so, the opposite conversion—of a fraction of a working interest into an overriding royalty interest—should also be a like-kind exchange. Interests in oil and gas in place are normally considered real estate under local law or are deemed to be real estate for tax purposes.⁹⁵ It follows that a royalty interest and a working interest are like-kind properties,⁹⁶ and therefore an overriding royalty interest and a fraction of a working interest are also like-kind properties. What happens in the *inter se* transaction would seem to fit the purpose of the like-kind exchange provisions, which is to protect transactions involving essential continuity of in-

90. For a discussion of this shift in interests, see text accompanying note 69 *supra*.

91. For a discussion of this distinction, see text accompanying notes 101-22 *infra*.

92. For a discussion of the first view of how assets are marshalled in the *inter se* transaction, see text accompanying notes 78-79 *supra*.

93. See notes 56-60 and accompanying text and text accompanying note 64 *supra*.

94. A. BRUEN & W. TAYLOR, *supra* note 12, ¶¶ 8.03[3] n.53; 8.10.

95. See, e.g., *id.* ¶ 8.10[1].

96. See ¶ 8.10[1] (citing Rev. Rul. 186, 1968-1 C.B. 354).

vestment from recognition,⁹⁷ since the value remains invested in the same property. The *inter se* transaction may therefore properly be viewed as a like-kind exchange. So viewed, it will not be a recognition event. The change in responsibility for future costs should not complicate a view of the *inter se* transaction as a like-kind exchange because that contingent responsibility is not a present debt, or liability.⁹⁸ This change is the same in the present comparative transaction as it is in the *inter se* transaction. Implicit in the conclusion that the *inter se* transaction is not a recognition event because it is a like-kind exchange is the second view of marshalling assets wherein the group participants give up all of one kind of interest in return for a similar or "like-kind" interest.⁹⁹

There are thus five analyses explaining why the *inter se* transaction should not be treated as a recognition event. Four of these are consistent with the first view of how the assets are marshalled; two are consistent with the second view. While the manner in which the assets are marshalled is conceptually interesting, its significance for tax purposes relates only to determining the available routes to nonrecognition. As an issue in its own right, the way in which the assets are marshalled cannot be resolved. Both marshalling views are viable and therefore neither can claim hegemony. Each is predicated on the understanding that the Group 1 and Group 2 participants entered the *inter se* transaction with undivided interests in the carried working interest of the lease fund.

V. THE ECONOMIC REALITIES

A. General Discussion

The economic realities underlying the contemplated transactions will ultimately determine the tax effects.¹⁰⁰ Each of the transactions discussed above, the initial basic industry model and the *inter se* restructuring, seems to contain strong elements of economic reality;¹⁰¹

97. See *Davis v. United States*, 589 F.2d 446, 449 (9th Cir. 1979); *Lakritz v. United States*, 418 F. Supp. 210, 211 (E.D. Wis. 1976); S. REP. NO. 1983, 85th Cong., 2d Sess. 72-73, reprinted in 1958 U.S. CODE CONG. & AD. NEWS 4791, 4862.

98. For a discussion of the effect of the contingent liability on the transaction, see text accompanying note 87 *supra*. See also note 122 and accompanying text *infra*.

99. This is the view which holds that while the sharing agreement is an exchange of rights, it is nevertheless nontaxable for policy reasons. For a discussion of these reasons, see notes 62-66 and accompanying text *supra*.

100. *Estate of Weinert v. Commissioner*, 294 F.2d 750, 752 (5th Cir. 1961).

101. The term "economic reality" is used herein in its normal English language sense. An inquiry into the economic realities of a transaction is thus simply an inquiry into its real economic substance. For a further discussion of the economic reality of transactions, see note 107 *infra*.

both reflect genuine economic, nontax changes in position. The transactions appear to be separate or separable. If this is true of the individual transactions and remains true when the transactions are combined, then the tax consequences which would attend the transactions if viewed in isolation should remain intact when the transactions are combined. This will now be explored.

When different parties engage in separate transactions, some will find the conclusion of economic reality inexorable. "Separate" may seem an absolute; either the transactions are separate or they are not. Unfortunately, life is not that simple. Separate transactions can, for instance, sometimes be found in a single set of documents, even though the parties to the transactions are not all the same. They can also occur simultaneously, although the more connections there are between transactions, the greater the likelihood of confusion.

With respect to the contemplated transactions the focus of the confusion is on the treatment of the cash paid up front in the initial transaction between the driller and the fund participants. If the initial transaction and the *inter se* transaction are viewed as separate, capital gain rather than ordinary income results to all of the fund participants. The danger in confusing the transactions is that the *inter se* transaction might seem to taint the cash received up front by the Group 2 participants in the initial transaction, thereby transforming it from capital gain into ordinary income.¹⁰²

Ideally, from the fund participants' points of view, any connection between the two transactions should be avoided. If possible, the documents should be separate and the transactions should occur at different times. It cannot be overemphasized that without complete separation, confusion is the likely result. Yet the more closely connected the two transactions, the clearer the focus on the ultimate theoretical issue discussed herein, which is whether capital gain treatment remains appropriate for the cash bonus received by the Group 2 participants in the initial, basic industry model transaction.¹⁰³

B. Order

Obviously, the *inter se* transaction must occur either subsequent to, or simultaneous with, the initial transaction. But even if they occur simultaneously, on a conceptual level the *inter se* transaction must

102. For a list of authorities on the tax treatment of this transaction, see note 72 *supra*.

103. For a discussion of this initial transaction, see notes 66-73 and accompanying text *supra*.

occur second. Should the Service try to designate the two transactions as something other than what they appear to be, it will have to mix the elements of the transactions together. The Service, therefore, cannot allow the fund participants the separateness in time which they may employ because it must attack the conceptual order the participants will want to claim.

If the *inter se* transaction were thought to occur first, then what was the initial transaction would be different in nature. Understanding this change is important to appreciating how the Service might attack the transactions if simultaneity or other non-essential connections are permitted to confuse what the participants believe they are doing. If the *inter se* transaction occurs first, then all of the working interest would be owned by the Group 1 participants at the time of what was (*and will continue to be called*) the initial transaction. The Group 2 participants would have only an overriding royalty interest at the time of the initial transaction. It seems obvious that since the Group 2 participants would have no working interest they could not sell a working interest. Thus, gain from cash flowing from the driller to the Group 1 participants, albeit through the lease fund, would be treated as capital gain; but gain from cash flowing to the Group 2 participants would look like ordinary income in the form of advance royalties. Under this view, the result sought by the Group 2 participants would be lost.

Unless the terms of each transaction are altered, there are serious difficulties with the economics of this conceptual reversal of the order of the two transactions. Although the reversal appears straightforward, it will leave the parties in a substantially different economic position from that contemplated. If the transaction were to proceed as proposed, the fund participants will part with a fractional share of the working interest in favor of the driller before creating the overriding royalty interest of the Group 2 participants in the *inter se* transaction. A critical aspect of this conceptual, if not actual, order (in time) is that the overriding rights of the Group 2 participants do *not* override the portion of the working interest held by the driller. They only override the portion held by the Group 1 participants. This must be true, because when the fund participants transact among themselves, the driller does not participate and the driller's interest cannot be subordinated to the overriding royalty interests of the Group 2 participants. However, if the *inter se* transaction were thought to occur first, *all* of the working interest will be involved, and therefore the overriding royalty interests of the Group 2 participants will override all of the working interest, including the portion destined for the

driller. Thus, this ostensibly simple placement of the *inter se* transaction prior to the initial transaction puts the parties in an entirely different position from that in which they would have been, and therefore lacks merit as a deemed restructuring.

In spite of the foregoing, two mechanical alterations to the conceptual reversal will overcome this difficulty and place the parties to both transactions back in the positions they would have been in under the contemplated transactions. A detailed analysis of the flow of assets in all three hypothesized fact patterns (the transactions as contemplated, plus each of these two deemed restructurings) is necessary to appraise the reasonableness of the deemed restructurings. First, each of the three hypothesized fact patterns will be described. They will then be compared. In all three scenarios it will be assumed that the fund participants have already acquired the working interest from the landowner, who in turn retained a royalty interest. The fund participants paid the landowner a cash bonus and undertook to pay all costs.

1. *Fact Pattern One: The Proposed Transactions*

In the first scenario, which embraces the transactions proposed in this article, the following events occur. In step one, the driller acquires a carrying working interest from the fund participants, who retain a carried working interest. The driller pays the fund participants a cash bonus, undertakes to pay the portion of costs allocable to the carrying working interest and agrees to the carry. In step two, the fund participants transact among themselves in the *inter se* transaction as to the carried working interest only. There are a total of only two transactions, or two steps, which take all parties to the point contemplated. The driller participates in only one transaction or step.

2. *Fact Pattern Two: An Alternative Deemed Restructuring*

In the second scenario, the timing of the two transactions is reversed, but a mechanical alteration corrects the priority problem discussed above. The events occur as follows: in step one, the fund participants transact among themselves in an *inter se* transaction as to the entire working interest. The Group 1 participants end up with all the working interest and the Group 2 participants end up with an overriding royalty interest which overrides the entire working interest. The Group 1 participants undertake to pay all costs. In step two, the driller acquires a carrying working interest from the Group 1 participants, who retain a carried working interest. The driller then pays the Group 1 participants a cash bonus, undertakes to pay the portion

of costs allocable to the carrying working interest and agrees to the carry. In step three, the driller pays cash to the Group 2 participants and acquires a portion of the overriding royalty interest from the Group 2 participants, who retain the remaining portion. Under this fact pattern, a total of three transactions are necessary to take all parties to the point contemplated, and the driller must participate in two.

3. *Fact Pattern Three: A Second Alternative Deemed Restructuring*

In the third scenario, events occur as follows: Initially (in what is not here counted as a separate step) the working interest is divided into two parts. In step one, the fund participants transact among themselves in an *inter se* transaction as to only one part of the divided working interest. After the transaction, the Group 1 participants are left with all of this portion of the working interest, and Group 2 participants are left with an overriding royalty interest in only that portion of the working interest. Thus, the Group 1 participants undertake to pay all the costs associated with that portion of the working interest, but both the Group 1 and Group 2 participants still retain their respective shares of the second portion of the working interest, together with their attendant shares of costs. In step two, the driller acquires a carrying working interest from the Group 1 participants, who keep a carried working interest, in just the first part of the working interest. The driller pays the Group 1 participants a cash bonus, undertakes to pay the costs allocable to the carrying working interest in just the first part and agrees to the carry in just the first part. In step three, the driller acquires a carrying working interest from the Group 1 participants, who keep a carried working interest, in just the second part of the working interest. The driller pays the Group 1 participants a cash bonus, undertakes to pay the costs allocable to the carrying working interest in just the second part and agrees to the carry in just the second part. In step four, the driller acquires *all* the working interest of the Group 2 participants in just the second part of the working interest. The driller pays cash to the Group 2 participants, who keep no interest in the second part of the working interest, and he undertakes to pay all costs allocable to the portion of the second part of the working interest which was owned by the Group 2 participants. The interest the driller acquires in this fourth step can be thought of as merging with the carrying working interest which the driller acquired in steps two and three.

Under this third scenario, a total of four transactions are necessary to take all parties to the point contemplated, and the driller must

participate in three. When the driller acquires a carrying working interest from the Group 1 participants as to both the first and second parts of the working interest, the driller and the Group 1 participants are the only parties in each transaction. These two transactions or steps could therefore be combined into one transaction or step. Even so, there would still be three total transactions, and the driller would have to engage in two of them.

4. *Analysis*

As we have just seen, it is obviously quite possible for the parties to both transactions—the initial transaction and the *inter se* transaction—to arrive at the same economic position even if the order of the two transactions is deemed reversed. Superficially, the fact that a deemed restructuring of the transactions produces more taxes for the government makes the two alternatives to the proposed transactions seem quite reasonable. What each party has before the transactions is obviously the same, no matter which transaction occurs first. What each has after the transactions is also the same, again regardless of the order. At this point the only difference may seem to be in the potential tax effect. The difference in how the parties get from the same antecedent positions to the same subsequent positions may appear to be merely a difference in how the soup is stirred.

What should a court do when faced with competing ways of looking at what happened? On different facts and issues, but faced with similarly competing versions of what happened, some courts have looked to what the parties actually did, rather than to what they could have done.¹⁰⁴ This approach would clearly leave the Group 2 participants with the tax result they desire. Thus, the taxpayers might win even if the transactions had occurred simultaneously in one set of documents.

There are a number of tax cases, however, where courts have imposed alternative structures or interpretations, thereby producing a larger tax.¹⁰⁵ These courts generally look for what may be called the

104. See *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978) (sale-and-lease-back not a sham); *Commissioner v. National Alfalfa Dehydrating & Milling Corp.*, 417 U.S. 134 (1974) (corporation could not consider fair value of preferred stock in calculating original issue discount for debentures issued in retirement of preferred stock); *Better Beverages, Inc. v. United States*, 619 F.2d 424 (5th Cir. 1980) (absent a demonstrable agreement, no part of a lump sum purchase would be allocated to covenant not to compete rather than to goodwill); *Murray v. Commissioner*, 601 F.2d 892, 893 (5th Cir. 1979) (“[a] transaction must be given its effect in accordance with what actually occurred and not in accordance with what might have occurred”).

105. See *Morton-Norwich Prods., Inc. v. United States*, 602 F.2d 270 (Ct. Cl. 1979) (the Service may restructure non-arms-length transaction between taxpayer

real substance of the transactions.¹⁰⁶ They look for the direct or straightforward way of taking the parties from the starting point to the concluding point. If the route adopted by the parties is comparatively convoluted, these courts will ignore it in favor of a more straightforward version of the events.¹⁰⁷ It is not common, however, for the transaction to be deemed restructured *solely* because more taxes will result.

The question, then, is which of the alternative routes discussed above is more straightforward. In each scenario a count was made of the number of discrete transactions or steps necessary to arrive ultimately at the same economic position. In the transaction as initially contemplated, there are two steps: the initial transaction followed by the *inter se* transaction. The driller is engaged in only the former, or just one, transaction. However, in both the second and third fact patterns there are at least three transactions; the driller, who is not concerned with the special *inter se* considerations of the fund participants, must participate in two of them. The number of transactions has increased by at least fifty percent.

The proposed transactions of the first fact pattern take the parties to the positions they desire in a simple, direct and straightforward way. They allow the driller to deal only once with a cohesive group of similarly situated fund participants. With either of the three-step alternatives, life becomes considerably more complicated for all involved, not just because the number of transactions increases, but also because of the reasons for the increases. If the *inter se* transaction were deemed to be first, then the number of transactions required to get

and controlled corporation), *cert. denied*, 445 U.S. 927 (1980); *Aristar, Inc. v. United States*, 553 F.2d 644 (Ct. Cl. 1977) (the Service can allocate interest income to eliminate income distortions resulting from interest-free loans between related taxpayers); *Hilton v. Commissioner*, 74 T.C. 305 (1980) (depreciation deduction disallowed for limited partners because sale-and-leaseback by which partnership acquired property was not a genuine and multiparty transaction with economic substance), *aff'd per curiam*, 671 F.2d 316 (9th Cir.), *cert. denied*, 459 U.S. 907 (1982). *Cf.* *Frank Lyon Co. v. United States*, 435 U.S. 561, 580 n.15 (1978) (Court suggested that not imposing an alternative structure may garner more taxes and, accordingly, held against the Commissioner).

106. Attacks that are variously labeled lack of economic reality, sham theory, and step transaction doctrine, are all different aspects of the principle that courts will scrutinize transactions according to their underlying business purpose. *See Gregory v. Helvering*, 293 U.S. 465 (1935). For a discussion of *Gregory*, and the different meanings which attend the use of these different terms, see 2 S. SURREY, W. WARREN, P. McDANIEL & H. AULT, *FEDERAL INCOME TAXATION: CASES AND MATERIALS* 672-78 (2d ed. 1980) [hereinafter cited as SURREY].

107. *See Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) (when reviewing the acts of the parties for economic significance, "[a] given result at the end of the straight path is not made a different result because reached by following a devious path").

the parties to the same point increases because the transactions themselves are fundamentally changed and therefore become considerably more complicated.

In the second scenario, for example, the *inter se* transaction is quite different because it applies to the entire working interest. Too, the initial transaction would be drastically different because the Group 2 participants would be transferring to the driller a fractional share of an overriding royalty interest instead of a fractional share of a working interest. This change is one of the reasons why the number of discretely identifiable transactions grows, reflecting the fact that what the Group 2 participants transfer to the driller is different in nature from the working interest which the Group 1 participants transfer. There is something strained about so drastically altering the timing of the transactions when doing so complicates rather than simplifies.

In the third scenario, the *inter se* rearrangement is even more complex. The fund's entire working interest is first divided into two parts and the *inter se* transaction applies to only one of them. Moreover, the fund participants must predetermine the precise size of the two portions and/or the precise quantity of override for the Group 2 participants in the first portion so that both groups are left with satisfactory rights when the driller's goals become known. This may require singular intuitive foresight. If the driller's goals were already known because all transactions are occurring simultaneously, the need to look first at what will satisfy the driller suggests the correct conceptual ordering of the transactions. As an aside, the same need to look at the entire transaction seems to exist when determining the terms of the initial transaction when the transactions occur in the order contemplated. The terms of an anticipated *inter se* transaction would certainly profitably inform the fund participants when they first deal with the driller. This response misses an important point, however: obtaining a driller who will do all the work and carry the fund to the casing point is of paramount importance—assuming that the fund participants, as is typically the case, are not drillers and never intended to do the actual drilling themselves.¹⁰⁸

Dividing the working interest into two parts in order to have the *inter se* transaction occur first appears strained. Where the *inter se* transaction occurs first, the natural way to proceed would be to give an overriding royalty interest to the Group 2 participants covering the entire working interest. However, if the working interest is to be

108. See A. YOUNG, *supra* note 9, ¶ 193.

divided into two parts, then the restructuring must face the strain referred to above because the Group 2 participants' override cannot ultimately cover the entire working interest without altering the final economic positions of the parties. This strain would seem to rip the fabric of any greater realism the scenario might have sought to weave into the transaction.

Although the foregoing suggests that the second scenario is more realistic than the third, the second contains its own unreality: in its last step, the driller acquires a portion of the Group 2 overriding royalty interest for cash. By contrast, the driller in the contemplated transactions (the first scenario) is interested in working interests and working interests only. It is true that he will have less proceeds rights if he does not make the acquisition, but it is also true that he will have more cash which he might prefer to use for working the property. The driller does not have to acquire a portion of the override and, indeed, he might not. If he is required to so acquire a part of the override as a condition of acquiring the working interest, we get a glimpse of what is really happening in this deemed restructuring. The driller is really seeking the working interest and, when he adds to his proceeds rights by acquiring a portion of an overriding royalty interest, he might see himself as actually acquiring the same working interest as he would in the transactions as contemplated. He might therefore think of the portion of the override thrust upon him as representing a somewhat smaller proceeds right in the form of part of the working interest he could have acquired had the deemed restructuring not forced acquisition of part of an override into his considerations.

Emerging from the foregoing analysis are the significant qualities of the two alternatives to the contemplated transactions: (1) they require more transactions to accomplish the same result; (2) they are more complicated in ways beyond the mere increase in the number of steps; and (3) each has an aspect of unreality. Taken separately, each of these qualities, when compared with the proposed transactions illustrated in the first scenario, should be sufficient to reject the alternatives. Taken together, they are compelling. The form proposed by this article is a straightforward way of viewing the substance. It is not convoluted. Being straightforward, it stands a reasonable chance of adoption by even a suspicious court. The alternative versions which the Service might seek to impose are tortuous diversions. Courts do not commonly adopt a less straightforward version of events solely for the purpose of increasing taxes.¹⁰⁹ Taxpayers should therefore have a

109. *See* *Frank Lyon Co. v. United States*, 435 U.S. 561, 579-80 (1978) ("there

very reasonable expectation of winning if challenged, even if the transactions had occurred simultaneously in a single set of documents.

Furthermore, the detailed analysis allows us to observe just what the Group 2 participants would be transferring to the driller for cash in each of the two deemed restructurings. In the second scenario, the outright transfer of a fraction of an overriding royalty interest by the Group 2 participants to the driller for cash sounds like a sale¹¹⁰ of a capital gain asset anyway. Similarly, in the third scenario, the outright transfer of a fraction of a working interest by the Group 2 participants to the driller for cash also sounds like a sale¹¹¹ of a capital gain asset. The overriding royalty interest with which the Group 2 participants end up in the third scenario does not pertain to the working interest they transfer to the driller.¹¹² The deemed restructurings would seem to have accomplished nothing. Nevertheless, for reasons suggested below, the Service may be troubled by the combination of transactions and may seek to have them viewed differently anyway.

C. *Structuring the Contemplated Transactions: Likely Circumstances*

Since there are potential alternative views of what occurs, and since Service curiosity may be piqued by a situation in which investors with a working interest receive cash, end up with only an overriding royalty interest, and yet claim the gain as capital gain, cautious tax counsel will probably want to minimize connections between the two transactions. Thus, if the ultimate issue is ever presented to a court, the facts may include three circumstances which increase in

are simply too many contingencies, including variations in the value of real estate, in the cost of money, and in the capital structure of . . . [the taxpayer], to permit the conclusion that the parties intended to enter into the transaction as structured [as] the Government now urges"). *But see* *Eli Lilly v. United States*, 372 F.2d 990, 997 (Ct. Cl. 1967) (quoting *Leedy-Glover Realty & Ins. Co. v. Commissioner*, 13 T.C. 95, 107 (1949) ("Our concern is more with the ultimate results arrived at by the Commissioner than the methods which he uses.")).

110. *See* A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.04, at 8-16; F. BURKE & R. BOWHAY, *supra* note 15, ¶ 3.03. It is the position of the Service that any assignment of an interest in which the transferor retains a nonoperating royalty interest will be treated as a lease. *See* Rev. Rul. 352, 1969-1 C.B. 34. However, a transaction will be treated as a sale whenever the owner of an interest transfers a fractional interest that is equivalent in nature to the interest retained, or when the owner assigns a continuing nonoperating interest and retains the working interest, or when the owner retains only a noncontinuing interest in production. F. BURKE & R. BOWHAY, *supra* note 15, ¶ 3.03.

111. *See* A. BRUEN & W. TAYLOR, *supra* note 12, ¶¶ 8.03[4], .04, at 8-15 to -16.

112. If this fact is not properly considered, this transaction or step would look like a lease. *See* A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.04, at 8-16.

merit in the following order, each circumstance being a step toward complete separation.

First, were the transactions to occur simultaneously, whether or not in one set of documents, the right of participants to become Group 2 participants could be drafted as an option which could be exercised later. No one would then know who, if anyone, would be a Group 2 participant or how many such participants there would be. The deemed restructuring would still be possible as to those participants who exercise the option. It would be more difficult, however, to maintain that they parted with the *inter se* portion of their working interest in part to obtain cash from the driller, since they would still have legal and equitable rights to that interest after receiving the cash. Indeed, they would have every right to keep that interest by not exercising their options.

Second, the opportunity to become a Group 2 participant could be made further contingent on the existence of a sufficient number of Group 1 participants to support the *inter se* transaction. Put differently, there could be an option to become a Group 1 participant, instead of an automatic obligation for failure to exercise the option to become a Group 2 participant. With the combination of these two options, the opportunity to sublease oneself into an overriding royalty position would be contingent not only on one's own action, but also on the actions of others: the *inter se* transaction would occur only if a sufficient number of participants exercised the Group 1 option to absorb the working interests being transferred and to cover the attendant share of costs.

Third, the parties could remove any connection between the two transactions by recording them in separate documents with the *inter se* transaction occurring second. No obligation whatsoever to enter into the *inter se* transaction would exist at the time of the initial transaction.

It should be noted that the position of the general partner is unique in all of this. It is obvious that just by reason of his participating in the *inter se* transaction he cannot become only a Group 2 participant; he will remain the general partner. It is also possible for him to become a Group 1 participant (here, too, remaining the general partner), but it would be important in the intermediate steps toward complete separation that he too have no obligation to be a Group 1 participant.¹¹³

113. The unique position of the general partner deserves further comment. Even with seemingly complete separation of the two transactions, it will remain possible for the Service to argue that the transactions were part of a prearranged scheme

Additional dimensions of the economic realities involved are relevant to consideration of deemed restructuring, but may remain relevant even if deemed restructuring has already failed.

D. *Some Additional Economic Realities*

The different parties involved and the terms of the transaction are important to the view that the two transactions are each economically realistic and independent of one another. Those two features are related. In the initial transaction, the Group 1 and Group 2 participants are on the same side, with the driller on the other side. The driller, who acquires the right to a share of the proceeds by agreeing to carry the lease fund to the casing point and to pay a share of costs thereafter, cannot profit from the *inter se* transaction since he is not a party to it. The presence of the driller in the initial transaction, coupled with his absence from the *inter se* transaction, seems to assure that the terms of the initial transaction are set at arm's length. Moreover, it should be observable that the terms of the initial transaction are comparable to the terms of similar, unrelated transactions where no *inter se* transaction is contemplated. The cash the driller pays to the lease fund in the initial transaction would therefore be paid only for what the driller gets in the initial transaction. It follows, then, that the cash received by the lease fund in the initial transaction is received only for what the lease fund gives up in the initial transaction. It is not received by reason of anything that happens in the *inter se* transaction.

Although the parties to the *inter se* transaction are related by common ownership of shares in the limited partnership which owns the lease fund, normally they are otherwise unrelated to each other. Since their interests are adverse in the *inter se* transaction, their relationship as common owners of the limited partnership should not taint what occurs in the *inter se* transaction. Unless something suspicious occurs in the *inter se* transaction, there is no ground for arguing that the *inter se* transaction somehow taints the initial transaction.

and that they should be integrated. The attack will have to point to participants in the scheme from both sides of the *inter se* transaction. The general partner will be a prime suspect for having set up the scheme even if he himself were not a Group 1 or Group 2 participant. Absent specific, detailed facts which cannot be known before an appropriate case arises, it can only be said that the issue will be for the trier of fact to decide. A successful attack based on this theory will, moreover, have to overcome the economic realities which attend the transactions.

If a prearranged scheme is not found, it will still be possible for the Service to attack on the ground that the general partner and others knew of the possibility that the *inter se* transaction might follow the initial transaction. An argument based on nothing more should fall on deaf judicial ears.

A further possible effort by the Service to purportedly "place substance over form" might be grounded in the notion that Group 1 and Group 2 participants act in unison at the time of the initial transaction. However, this pursuit of common interests by related parties cannot directly taint the initial transaction because of the presence of the driller. Moreover, it cannot taint the *inter se* transaction since the Group 1 and Group 2 participants become adverse in the *inter se* transaction. But even if it did, the taint will not deleteriously affect the *inter se* transaction for two reasons. First, there is no cash present in the *inter se* transaction. Second, even if cash were received in the *inter se* transaction, any recognized gain would be treated as ordinary income under some of the tax approaches to the *inter se* transaction regardless of whether the *inter se* transaction were tainted.

If the *inter se* transaction were tainted, could that taint spread to the initial transaction, where cash is present and capital gain treatment for the cash is expected? It seems not, for the same reason that the initial transaction could not be tainted by the common interests of the Group 1 and Group 2 participants in the initial transaction. The driller is present.

It is difficult to restructure the two transactions for the purpose of placing substance before form because the form already reflects the substance of the transactions. Nevertheless, the Service will probably be troubled by the fact that cash received in the initial transaction by the Group 2 participants is treated as capital gain even though the Group 2 participants are left with only an overriding royalty interest after the *inter se* transaction. Usually, when a person with a working interest receives cash and an overriding royalty interest, and otherwise parts with his working interest, the cash is supposed to be treated as ordinary income. As already mentioned, this will be the result if the two transactions were not viewed as separate. The Service can, therefore, be expected to scrutinize closely transactions following the theme suggested.¹¹⁴

To crystalize an attack, could the Service simply point to an alternative standard transaction which achieves these tax results? In this standard transaction, the lease fund participants transfer all of the working interest they acquired from the landowner, subject only to retention of an overriding royalty interest, to the driller, receiving cash as sublease bonus income and benefitting from an undertaking by the driller to cover all costs. The Service could argue that this

114. For a summary of the Service's position that a lump sum payment received by the grantor of mineral rights who retains a royalty interest is ordinary income, see Rev. Rul. 352, 1969-1 C.B. 34.

standard transaction represents all that happened as far as the Group 2 participants are concerned, and that it places the Group 2 participants simply and directly in precisely the position at which they arrived.

The similarity is only superficial, however. There is a key difference between the economic position arrived at in this short, focused attack and the real position of the Group 2 participants in the transactions as contemplated. In the standard transaction used here for comparison, the overriding royalty interest overrides all proceeds rights of the driller. By sharp contrast, the contemplated transactions will produce an override only as to the carried working interest of the Group 1 participants. In subordinating the proceeds rights of the Group 1 participants, the override of the Group 2 participants achieves priority equal to the driller's proceeds rights after payout, but no more.

This line of critical inquiry thus makes the same mistake which is made by arguing that the *inter se* transaction preceded the initial transaction. Furthermore, the attack could also be faulted for ignoring the actions of the parties. Comparison of the contemplated transactions with the alternative standard transaction does have initial superficial appeal, but it simply does not withstand critical analysis. Simply ignoring the two transactions which do occur will not work. Rather, the Service will have to seek to integrate the two transactions. Thus, were the Service to attack, one can count on it to point to the combination of capital gain treatment claimed by persons who retain only an overriding interest. But an attack based solely on these grounds should fail because the capital gain treatment and the retention of only an overriding royalty interest occur in separate transactions. To base the attack on other grounds will require claiming that the separateness of the transactions lacks economic reality. This has already been addressed.

E. *Particular Partnership Considerations*

The two most important issues addressed in this article, the tax effect of the *inter se* transaction itself and, the more important of the two, the effect of the *inter se* transaction on the cash received up front in the initial transaction, are most clearly raised in the framework of the partnership form. In fact, if ever litigated, the partnership form would almost certainly be involved.

Particular partnership considerations are not the major concern, however, and the tax issues discussed transcend the particular form. The discussion therefore intentionally looks past business form to the

underlying substantive issues. Tax considerations of the partnership form which are routine in the context of limited partnership lease fund transactions will not be discussed.¹¹⁵ Having dealt with some of the structural peculiarities of an oil and gas lease fund limited partnership,¹¹⁶ some tax considerations raised by the underlying transactions which are both unusual for transactions of this type and peculiar to the particular business form of the limited partnership will now be considered.

Acquisition of the lease, engagement of the driller and creation of the carried/carrying working interest relationship fit within the normal range of oil and gas limited partnership activities and do not raise unusual tax complications. The *inter se* transaction is unusual. Effecting it through the partnership form therefore raises issues not commonly found in limited partnership lease fund transactions in the industry.

There are two distinctly different ways of placing the Group 2 participants, in their capacity as limited partners, in the ultimate position described above. A distribution of overriding royalty rights could be made in complete liquidation of the partnership interest of each Group 2 participant. Alternatively, the distributive shares of the Group 1 and Group 2 partners in profits and losses could be altered by amending the partnership agreement.

Distribution of overriding royalty rights made in complete liquidation of the partnership interests of the Group 2 partners would involve creating the overriding royalty interest they must receive. It would be tantamount to a nonproportional distribution of assets because of the smaller proceeds rights which inhere in an overriding royalty interest. The distributions would be free and clear of responsibility for costs, which would be picked up completely by the Group 1 partners, who would then be the only limited partners left. There is little reason for persons with only overriding rights, free of costs, to remain in the partnership. The feeling should be mutual. Such distributions of overriding royalty interest are not recognition events for the Group 2 individuals.¹¹⁷

Amendment of the partnership agreement altering the distributive shares of the Group 1 and Group 2 partners in the profits and

115. For a discussion of the tax considerations relevant to the choice of organizational form for natural resource ventures, see Burke & Meyer, *Federal Income Tax Classification of Natural Resource Ventures: Co-Ownership, Partnership, or Association?*, 37 Sw. L.J. 859 (1984).

116. For a discussion of the structure of the limited partnership, see note 10 and accompanying text *supra*.

117. See I.R.C. § 731(a) (1982).

losses of the partnership would create an overriding position in the Group 2 partners if for some reason it were considered desirable for the partners to stay together. The Group 1 partners would get all the profits in excess of the overriding royalty and would be made responsible for all future contributions to the partnership necessary to cover the limited partners' responsibility for costs. The Group 1 rights to this larger share of profits would thereby be subordinated to the reduced share of profits of the Group 2 partners. The rights of the Group 2 partners would amount to rights to a share of gross revenues since any costs or expenses would have to be borne by the Group 1 partners out of whatever revenues are left. It is contemplated that all monies previously contributed to the partnership would already have been used for acquisition of the lease (or leases) or for expenses incident thereto. The Group 2 partners will then be left with no rights to any future distributions of property from the partnership other than those distributions attributable to their override. The Group 1 partners, including the general partner, will have a distributive share among them of 100% of losses and all deductible items which reduce profits or contribute to losses, with the single exception of depletion. The Group 2 partners will have the rights to depletion which attend their share of proceeds rights. The law generally does allow contractual variation in items of income, loss or deduction.¹¹⁸ The rearrangement of rights within the partnership by amendment of the partnership agreement is not conceptually different from any other such modification, whether originally contemplated or accomplished by amendment. That these changes are not themselves recognition events, except under certain circumstances involving changes in the share of liabilities of particular partners, does not appear to have been questioned. This result is consistent, as it should be, with the first alternative: the distribution of an overriding royalty interest in complete liquidation of a partner's interest. The position of the Group 2 partners who remain in the partnership is not substantively different from what it would have been if they had opted out.

That a shift in the partners' shares of liabilities could be a recognition event deserves special comment. The potential problem is that just as an increase in a partner's share of liabilities is treated as a contribution of money,¹¹⁹ so also a decrease in a partner's share of liabilities is treated as a distribution of money.¹²⁰ Any distribution of money in excess of a partner's adjusted basis in his partnership inter-

118. *See id.* § 704(a).

119. *See id.* § 752(a).

120. *See id.* § 752(b).

est would be recognized.¹²¹ This is a potential difficulty for the Group 2 partners whether or not they stay in the partnership. It should not, however, be a difficulty here because the responsibility for future costs is not yet a liability and it may never become one.¹²² It is contingent and its quantity is impossible to calculate.

VI. POLICY DIMENSIONS

The social policy dimensions of federal income taxation law are important in determining what the law is and how it is to be applied. Congress has made a policy determination that "income" is not necessarily "income," since not all income is taxed.¹²³ For income which is taxed, there are two fundamentally different ways of taxing it. In case of an individual, if income qualifies as long-term capital gain, then only forty percent of the income is taxed.¹²⁴ The other kind of income is appropriately called ordinary income¹²⁵ because the exclusion of sixty percent of long-term capital gain from the basic taxing mechanisms is truly extraordinary. The wisdom of such a bifurcation of income has been commented upon frequently.¹²⁶ The wisdom of a bifurcation which manifests itself in the manner of the present capital gains provisions has also been the focus of considerable comment.¹²⁷

121. *See id.* § 731(a)(1).

122. *See, e.g.,* Long v. Commissioner, 71 T.C. 1 (1978), *modified*, 81-2 U.S. Tax Cas. (CCH) ¶ 9668 (10th Cir. 1981); Associated Patentees, Inc., 4 T.C. 979 (1945). *See also* W. MCKEE, W. NELSON & R. WHITMIRE, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 7.01 (1978). *Cf.* CRC Corp. v. Commissioner, 693 F.2d 281 (3d Cir. 1982); Brontas v. Commissioner, 692 F.2d 152 (1st Cir. 1982), *cert. denied*, 103 S. Ct. 2453 (1983); Zappo v. Commissioner, 81 T.C. 77 (1983); Denver & Rio Grande W. R.R. v. United States, 505 F.2d 1266 (Ct. Cl. 1974); Gibson Prods. Co. v. United States, 460 F. Supp. 1109 (N.D. Tex. 1978), *aff'd*, 637 F.2d 1041 (5th Cir. 1981). For a discussion of the contingent nature of the debt, see note 87 and accompanying text *supra*.

123. *See, e.g.,* I.R.C. §§ 101-132 (1982).

124. *Id.* § 1202(a). The minimum tax provisions may, of course, apply. *See id.* §§ 55-58.

125. *See, e.g., id.* § 64 ("the term '[o]rdinary income' includes any gain from the sale or exchange of property which is neither a capital asset nor property described in § 1231(b)").

126. *Income Tax Revision: Hearings, Before the House Comm. on Ways & Means*, 86th Cong., 1st Sess. 13-14 (1959) (testimony of Walter J. Blum) [hereinafter cited as Testimony of W. Blum]; H. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 148-68 (1980); Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247 (1957); Katsoris, *In Defense of Capital Gains*, 42 FORDHAM L. REV. 1 (1973); Waggoner, *Eliminating the Capital Gains Preference Part I: The Problem of Inflation, Bunching, and Lock-in*, 48 U. COLO. L. REV. 313 (1977) [hereinafter cited as Waggoner, Part I]; Waggoner, *Eliminating the Capital Gains Preference. Part II: The Problem of Corporate Taxation*, 49 U. COLO. L. REV. 9 (1977) [hereinafter cited as Waggoner, Part II].

127. *Income Tax Revision: Hearings Before the House Comm. on Ways & Means*, 86th Cong., 1st Sess. 675-78 (1959) (testimony of Stanley S. Surrey) [hereinafter cited as

The basic idea and the particular manifestation are both subject to attack. These attacks take the form of policy arguments to repeal the bifurcation¹²⁸ or to change its particulars.¹²⁹ They also take the form of policy arguments to interpret narrowly the applicability of the capital gains provisions when their application is not appropriate in view of the policies underlying the provisions.¹³⁰

1959 testimony of S. Surrey]; *General Revenue Revision: Hearings Before the House Comm. on Ways & Means*, 85th Cong., 2d Sess. 2281-91 (1958) (testimony of Stanley S. Surrey) [hereinafter cited as 1958 testimony of S. Surrey]; Brinner, *Inflation, Deferral and the Neutral Taxation of Capital Gains*, 26 NAT'L TAX J. 565 (1973); Katcher, *A Critique of Capital Gains Taxation Problems and Proposals*, 14 U.S. CAL. TAX INST. 769 (1962); Rockler, *Frolics and Detours in Capital Gains*, 41 TAXES 858 (1963); Tudor, *Exemption of Capital Gains from the Capital Gains Tax*, 35 TAXES 101 (1957) [hereinafter cited as Tudor, *Exemption*]; Tudor, *The Equitable Justification for the Capital Gains Tax*, 34 TAXES 643 (1956) [hereinafter cited as Tudor, *Justification*]; Note, *A Spreading of Receipts Formula for Creating A Capital Gains/Ordinary Income Brightline: Contract Termination Payments and Business-Versus-Investment Assets*, 87 YALE L.J. 729 (1978).

128. See Testimony of W. Blum, *supra* note 127, at 13-14; Waggoner, *Part I*, *supra* note 126, at 313; Waggoner, *Part II*, *supra* note 126, at 9.

129. See 1959 testimony of S. Surrey, *supra* note 127, at 675-78; 1958 testimony of S. Surrey, *supra* note 127, at 2281-91; Brinner, *supra* note 127, at 565; Katcher, *supra* note 127, at 769; Tudor, *Exemption*, *supra* note 127, at 101; Tudor, *Justification*, *supra* note 127, at 643; Note, *supra* note 127.

130. An example of such narrow interpretations can be seen in the use of the word "property" in certain tax applications. See generally I.R.C. § 1221 (1982) (definition of "capital asset"). While the word "property" has an ordinary, everyday meaning, that meaning is often irrelevant in tax applications. Some items which are property in the normal sense are excluded from this tax meaning of property. For specific examples of this phenomenon, see *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 264-67 (1958) (oil payment rights); *Corn Prods. Refining Co. v. Commissioner*, 350 U.S. 46, 50-51 (1955) (corn futures); *Hort v. Commissioner*, 313 U.S. 28, 31 (1941) (an unexpired lease). Another obvious example is the right to receive wages. These items are excluded from the meaning of the word property here, even though they are not in a list of five exceptions provided by the Internal Revenue Code. See I.R.C. § 1221 (1982); *Commissioner v. Gillette Motor Transport*, 364 U.S. 130 (1960). Statutorily, a "capital asset" is "property held by the taxpayer," subject to five exceptions. I.R.C. § 1221(1)-(5) (1982). In its interpretation of this section, the Supreme Court has held that "capital asset," and by implication "property," must "be construed narrowly in accordance with the purpose of Congress to afford capital gain treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus, to ameliorate the hardship of taxation of the entire gain in one year." *Commissioner v. Gillette Motor Transport*, 364 U.S. 130, 134 (1960) (citing *Burnet v. Harmel*, 287 U.S. 103, 106 (1932)). See generally Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985, 987-89 (1956). The opportunity for special interpretation of the meaning of "property" in § 1221 for policy reasons is more striking when compared to much broader interpretation of the same word for purposes of installment sales under the tax law. See *Realty Loan Corp. v. Commissioner*, 478 F.2d 1049 (9th Cir. 1973). In *Realty Loan*, the Commissioner argued that the contract rights would not be "property" for purposes of achieving capital gain treatment, and that they therefore could not be property for purposes of achieving installment sale treatment. *Id.* at 1050-51. The circuit court pointed out that the capital gain meaning of "property" turned on the special congressional purpose in enacting the capital gains provisions and that this purpose was absent in the installment sale area. *Id.* at 1051. It stated that the

Assuming the existence of only the initial transaction, without the *inter se* transaction, the following arguments can be made in favor of capital gain treatment. The property rights sold are distinguishable in nature from labor provided, and from property sold in the ordinary course of a trade or business.¹³¹ By contrast, in the initial transaction there is a one-time, or only occasional, sale of a fractional interest in accumulated capital.

The invested capital has been held for what is referred to as a long period of time (over six months).¹³² The gain recognized all at once at the time of disposition therefore represents appreciation in value which has occurred over a long period of time. Recognition all at once unfairly bunches the income into higher rate brackets than income realized more evenly over time from wages or from sales in the ordinary course of a trade or business. During the past twelve years the oil and gas industry has been subjected to particularly volatile price and cost increases. The bunching argument applies here, therefore, with particular force.

Because the appreciation has occurred over an extended time period, it is partially attributable to inflation. Inflationary gain is not real gain. To tax it is therefore to tax a return of capital. This, it is maintained, is not only bad policy but possibly impermissible under the sixteenth amendment.¹³³ If it is taxation of a return of capital, it is certainly not theoretically pleasing for a tax which is called an "income tax."

Leaving more capital in the hands of investors by taxing them less will stimulate the economy. This is thought to happen for a number of reasons. More capital is left in the hands of those who have a demonstrated ability to manage capital and to do so profita-

definition of "property" for purposes of § 1221 is *sui generis*. *Id.* (citing Commissioner v. Gillette Motor Transport, 364 U.S. 130 (1960)). By contrast, the court held that for purposes of the installment sales provisions, "property" retains its "natural and normal meaning." *Id.* at 1052.

131. Stock in trade, property properly includable in inventory, and property held primarily for sale in the ordinary course of business are specifically excluded from the definition of "capital asset" in § 1221. *See* I.R.C. § 1221(1) (1982); *id.* § 1231(b)(1)(A), (b)(1)(B) (inventory excluded from meaning of property used in trade or business). However, working interests, or portions thereof, would not be stock in trade unless the holder of the interest regularly engaged in the sale of working interests. *Cf. id.* § 1236 (relating to gain from sale or exchange of asset held by dealers in securities).

132. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 1001, 98 Stat. 494, 1011, *reprinted in* 6A 1984 U.S. CODE CONG. & AD. NEWS (amending 26 U.S.C. § 1222). This act reduced the holding period required to earn long-term capital gain treatment from "more than one year" to "more than six months." *Compare id. with* 26 U.S.C. § 1222(a) (1982).

133. *See* Waggoner, *Part I, supra* note 126, at 335-62, 375-78.

bly. Ameliorating the tax impact of a capital gain transaction increases the mobility of capital out of unprofitable or less profitable economic sectors and into those which are more profitable. Similarly, within particular economic sectors, capital gain treatment enhances the ability to move cash out of unprofitable or less profitable investments and into those offering greater profitability. The end result is increased efficiency, both in the economy as a whole and in particular sectors of the economy.

The applicable classification provisions state that the property rights sold are property within the meaning of section 1221 and either do not fall within its five exceptions¹³⁴ or can be classified as real property used in a trade or business.¹³⁵ Either way, the same tax result follows on sale at a gain. If the property is a capital asset, the gain is capital gain. If the property is not a capital asset because it is property used in a trade or business, then section 1231 provides that gain from its sale or exchange will be treated as capital gain anyway.¹³⁶ All of this follows because what is parted with is a share of invested capital. The transaction does not occur in the ordinary course of a trade or business.

These factors favor special taxation treatment in order to encourage investment in the capital stock of America. They are particularly applicable when the highly risky quest for new oil and gas reserves is involved.¹³⁷ The classic capital gain transaction involves

134. I.R.C. § 1221(1)-(5) (1982). The five exceptions include: (1) inventory or stock in the taxpayer's trade or business; (2) depreciable or real property used in the trade or business; (3) a copyright or similar asset; (4) accounts or notes receivable which were acquired in the course of the trade or business; and (5) publications of the United States government. *Id.*

135. *See* Spragins, Jr. v. United States, 78-1 U.S. Tax Cas. (CCH) ¶ 9,475 (N.D. Tex. 1978); Colman v. United States, 62-1 U.S. Tax Cas. (CCH) ¶ 9,241 (D. Utah 1961); Sledge v. United States, 56-2 U.S. Tax Cas. (CCH) ¶ 10,033 (N.D. Tex. 1956). As long as the transferor is not a dealer, a working interest is characterized as "real property" used in a trade or business within the meaning of § 1221 and § 1231. Rev. Rul. 226, 1968-1 C.B. 362; A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.04[2](a). *See also* Rev. Rul. 395, 1977-2 C.B. 80.

136. I.R.C. § 1231 (1982), *amended by* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 1001(b)(15), 98 Stat. 494, 1011-12, *reprinted in* 6A 1984 U.S. CODE CONG. & AD. NEWS.

137. The risk is not limited to the inability to predict whether oil or gas will be found in a particular well in meaningful quantities. For instance, the price of a barrel of crude oil is very significant in determining whether or not particular oil quantities are economic quantities. Drake's first oil sold for one dollar per gallon. A. CONE & W. JOHNS, PETROLIA 14 (1870). Two years later the going rate was fifteen cents per barrel. *Id.* During this time small ventures in the Titusville area ceased operations. *Id.* During 1982 and through mid-1983 the price per barrel fell over 14% and many smaller oil companies were forced to declare bankruptcy. *Back to Reality for the Oil Industry*, U.S. NEWS & WORLD REP., Mar. 14, 1983, at 21. Those that avoided bankruptcy did so by laying off virtually all employees. *Id.* at 22. Thus, novel ap-

the sale of corporate stock,¹³⁸ which is normally much more readily marketable than oil and gas properties.¹³⁹ The latter will more frequently have to be disposed of at times and prices for which their owner must be more flexible.¹⁴⁰ If the foregoing policy objectives are achieved when only the initial transaction is involved, they are no less achieved when the *inter se* transaction is added.

In a classic capital gain transaction, the sale of corporate stock, it would not normally occur to the Service to look to see what the seller did with additional stock in a second transaction in order to determine the appropriate characterization of the first transaction. The presence of an unrelated buyer of the stock may be all that is needed to give the first stock sale economic reality.¹⁴¹ The second transaction is only relevant to the first if the transactions are not viewed as separate, a dimension already addressed.¹⁴² Otherwise, the tendency is, if anything, to the contrary. The first transaction profitably informs an understanding of how to treat the second, not vice versa.¹⁴³

Nevertheless, the special capital gain taxation received by the Group 2 participants is somehow troubling. The following factors argue against capital gain treatment for the Group 2 participants under the contemplated transactions.

The difference between selling the property rights involved here and providing labor for wages is a distinction which depends on wealth. Only the wealthy are in a position to enter into this combination of transactions.

Ongoing sales of property in the ordinary course of a trade or business involve the use of invested capital. Even routine sales of inventory are sales of capital in an economic sense. In the economic division between capital and labor, it is clear that a sale from inventory is not purely a sale of labor. Yet gain from these arguably similar transactions does not get favorable capital gain treatment,¹⁴⁴ even when the gain is uneven over time.

The long-term capital gain holding period, six months and a

proaches in obtaining the tax benefits intentionally conferred by Congress are necessary if the discovery rate for new domestic crude oil and gas reserves is not to remain very low for some period of time.

138. See 1 SURREY, *supra* note 106, at 992-93.

139. See A. BRUEN & W. TAYLOR, *supra* note 12, ¶ 8.04, at 8-16.

140. *Id.*

141. See 2 SURREY, *supra* note 106, at 675-78. Cf. I.R.C. § 1239 (1982) (transactions between related taxpayers).

142. See text following note 103 *supra*.

143. See, e.g., *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

144. See I.R.C. § 1221(1) (1982).

day, is not sufficiently long to assure that the income is truly bunched. It may be that six months' income is bunched in one day, but that does not place the recipient in a higher tax bracket than he would be in if the same six months' income had been earned evenly over a year. And a capital gain transaction entered into once every six months can produce an income flow that is quite level over a period of years, even when the asset sold in each transaction has been held for many years.

The argument that bunching does not justify special treatment applies with particular force to the classic capital gain transaction, the sale of corporate stock. Stock ownership is readily divisible by selling only some of the shares owned. Shares of stock of the same class in the same company are fungible. People can and do sell shares of stock once a year, or more often, thereby obtaining a regular, even flow of income which is treated as capital gain.

Moreover, the income averaging provisions, sections 1301-1305, are designed to ameliorate any hardship caused by bunching.¹⁴⁵ While these provisions would be available if special treatment for capital gain were removed from the code, they are presently also available for any significant bunching caused by inclusion of the forty percent capital gain left after the sixty percent long-term capital gain deduction is taken. If bunching is a problem, a solution which says that sixty percent of the income is not income at all is as crude a solution as is imaginable.

The brevity of the long-term capital gain holding period, particularly in the context of different rates of inflation in different sectors of the economy and even for different products in the same market sector, does not assure that any significant inflation gain will be reflected in the amount realized on sale of particular assets.¹⁴⁶

It may be true that some economic stimulation results from taxing capital gain favorably, but the means of accomplishing this are government subsidies for the wealthier members of society.

The problems with these and other arguments against capital gain treatment for the Group 2 participants is that they apply equally to all persons who engage only in the initial transaction. The objections to capital gain treatment for the Group 2 participants, while wholly legitimate, are therefore really arguments to repeal the bifurcated treatment of income or to change the particulars of the bifurca-

145. *Id.* §§ 1301-1305.

146. However, increases in taxes resulting from being pushed into higher rate brackets by inflation are somewhat alleviated by adjustments to the tax tables to reflect inflation. *See id.* § 1(f).

tion. They are not grounds for singling out the Group 2 participants for loss of the special benefits.

VII. CONCLUSION

The structural variation on the standard oil and gas industry model for limited partnership lease fund transactions that has been analyzed in this article is but another way in which the standard transaction may evolve. The investors' opportunity for additional flexibility in the manner of achieving capital gain treatment, while at the same time repositioning themselves in a less risky position, is an attraction which can lure more capital into the industry. It will certainly leave more capital in the hands of those who have shown an inclination to invest in the industry.

In the structural variation, an investor seeks to obtain capital gain treatment for an initial cash payment while ending up with an overriding royalty interest. He does so by keeping separate, in two transactions, the means of achieving each. In the initial transaction, capital gain is sought by selling for cash a fractional share of what is a capital gain asset—a working interest. The investor then transforms his working interest into what was a lesser-included interest, a royalty interest. He does this by transferring a fraction of his right to receive proceeds to other owners of the working interest who, in return, take over his responsibility for costs.

If the necessary transactions are structured in the manner discussed herein, then there are substantial economic realities which attend the transactions. These economic realities argue strongly in favor of recognizing the separateness of the transactions for purposes of federal taxation law.¹⁴⁷ The cash received up front in the initial transaction with the driller should therefore be considered capital gain to Group 2 participants.

Thus, the contemplated combination of transactions should be viewed as a creative means of obtaining for the oil and gas industry the special benefits intentionally conferred by Congress, rather than as an abusive manipulation of the taxing mechanisms. If the result is undesirable on tax policy or other grounds, then it can be deemed one

147. Firm conclusions in this area are difficult to reach. Many decisions in recent years have wrestled with the issue of whether what appears a sale should be treated as a lease, with clear criteria having yet to be developed. See Mandel & Marlo, *Mineral Properties—Exploration, Acquisition, Development and Disposition*, 15-5th TAX MGMT. (BNA) PORTFOLIOS (1981). It is common for courts to look through transactions cast in the form of sales to find leases. See generally Schmid, *Economic and Nonoperating Mineral Interests*, 151-2d TAX MGMT. (BNA) (1980). The problem is exacerbated when transactions include new twists.

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more minor addition to the list of undesirable results which flow from the present capital gain provisions. The argument, however, should focus on changing the provisions, not excluding the proposed transactions from capital gains treatment.

It remains to be seen whether the oil and gas industry will attempt the restructured combined transactions. The attractions may prove too tempting not to try. If so, it will be only a matter of time to see whether judicial concurrence follows.

